

Resilience and Growth Prospects in a Shifting Global Economy



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Inter-American Development Bank

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Preface

Latin America and the Caribbean enters 2026 with resilience. Growth has been steady, and labor markets in several economies are operating with historically low unemployment. Spreads on sovereign debt remain contained and, in many cases, close to the lowest levels observed in recent decades.

Yet resilience does not imply immunity. Despite recent performance, growth remains modest. Long-standing structural constraints—particularly weak productivity growth—continue to limit the region’s ability to generate sustained and inclusive income gains. Financing conditions remain tight, as global long-term interest rates stay elevated, increasing borrowing costs and shaping fiscal dynamics across the region. Higher global interest rates and accumulated debt are translating into larger debt-service burdens, exerting pressure on both public finances and external accounts and further narrowing policy space. Together, these dynamics leave the region exposed to shifts in global risk sentiment and changes in external financing conditions.

Against this backdrop, rapid technological transformation is reshaping the global economy, and Latin America and the Caribbean is no exception. Advances in digitalization and artificial intelligence offer significant potential to raise productivity and reinforce macroeconomic policy management. These tools can enhance tax administration, increase spending efficiency, deepen financial markets, and improve the design and implementation of economic policy more broadly.

At the same time, the combined forces of technological change and the global transition toward lower emissions are increasing demand for many of the region’s natural resource endowments, particularly critical minerals essential for clean energy systems, electrification, and emerging technologies. This shift creates a strategic opportunity to attract investment, diversify exports, and embed the region more deeply in evolving global value chains.

However, technological progress and resource abundance will not automatically translate into inclusive, productivity-led growth. Realizing these gains requires credible macroeconomic frameworks and policies that foster an environment conducive to long-term investment while ensuring that the benefits are broadly shared across the population. Without strong institutions and clear policy direction, new opportunities may generate volatility and short-term windfalls rather than durable improvements in productivity and living standards.

This report examines how the region can sustain resilience under persistent pressures while positioning itself to benefit from new global transformations. It analyzes evolving external risks, fiscal and monetary challenges, shifts in global trade and financing conditions, and the strategic importance of commodities and technological change.

The central message is clear: resilience must be preserved, but resilience alone is not enough. Durable growth will depend on rebuilding buffers, strengthening institutions, and adopting policies that convert technological change and resource endowments into sustained productivity gains.

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CHAPTER 1

The Economic Outlook

Latin America and the Caribbean enters 2026 facing a complex and uncertain global environment. Just as they did in 2025, heightened geopolitical tensions, shifts in trade policies, and elevated global interest rates shape the external environment. Meanwhile, rapid advances in digital technologies and artificial intelligence (AI) are having visible macroeconomic effects, particularly in advanced economies, where they increasingly support investment and growth. Nevertheless, global growth remains moderate overall, with the long-run deceleration in China expected to continue, limiting external demand. Together, these forces are expected to persist into 2026, providing limited external tailwinds for growth in the region.

Despite this challenging backdrop, Latin American and Caribbean economies have shown resilience. Growth has remained modest but steady, labor markets have continued to perform well—with unemployment rates at or near their historical minimum across the region—and sovereign risk premia have reached historically low levels. Exchange rates appreciated against the U.S. dollar in many countries throughout 2025, and inflation has been largely contained. This performance contrasts with past episodes of heightened global uncertainty, which were often associated with capital outflows, sharp currency depreciations, and financial stress in the region. Such achievement suggests that years of institutional strengthening in fiscal and monetary policy frameworks have paid off.

Important vulnerabilities nonetheless remain. Growth is insufficient to close income gaps, while long-term interest rates in advanced economies have stayed elevated—reflecting continued uncertainty and the rapid expansion of global public debt—and are likely to remain a constraint on financing conditions for the region. Combined with already high public debt levels, higher interest payments are increasingly weighing on public finances and external accounts. If left unaddressed, these pressures could gradually erode the region's resilience.

At the same time, new opportunities are emerging. Advances in digital technologies offer scope to improve tax collection, strengthen payment systems, and enhance overall fiscal and monetary policy management. In parallel, digitalization and the global energy transition are boosting demand for critical minerals, opening a new window of opportunity for investment, exports, and public revenues in a region richly endowed with such resources.

Looking ahead, Latin America and the Caribbean will face the dual challenge of preserving macroeconomic stability while addressing deep structural constraints,

including low productivity growth, rapid demographic change that increasingly limits labor force–driven expansion, and low resilience to extreme weather events, alongside the risks associated with the transition toward lower emissions. As demographic tailwinds fade, productivity-led growth becomes central, and harnessing emerging technological and commodity-driven opportunities will be essential to support more resilient and inclusive growth.

Global and Regional Growth Outlook

Despite heightened geopolitical tensions, shifts in trade policies in major advanced economies, and persistently high interest rates, economic activity has remained resilient globally. In 2025, global growth is projected at 2.9 percent and in 2026 at 2.8 percent, broadly in line with projections made in early 2025 (Figure 1.1).

Growth for the euro area is expected to be slightly above 1 percent in both 2025 and 2026, marking an improvement over 2023 and 2024, when activity was directly affected by the war in Ukraine and related constraints on energy supply. In contrast, growth in the United States is projected to remain around 2 percent in 2025 and 2026, representing a deceleration from the 2.8 percent average observed in 2023–24. Although labor market conditions in the United States softened toward the end of 2025, investment related to artificial intelligence has helped support economic activity and is expected to be increasingly important in the years ahead. Meanwhile, China's economy is projected to continue its long-term deceleration, with growth slightly below 5 percent in 2025 and falling below 4 percent by the end of the decade (IMF 2025b).

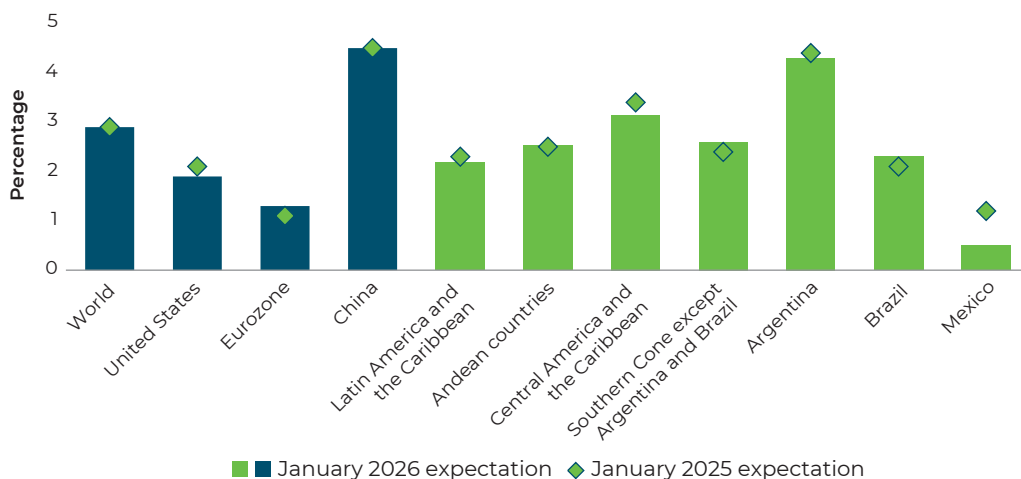
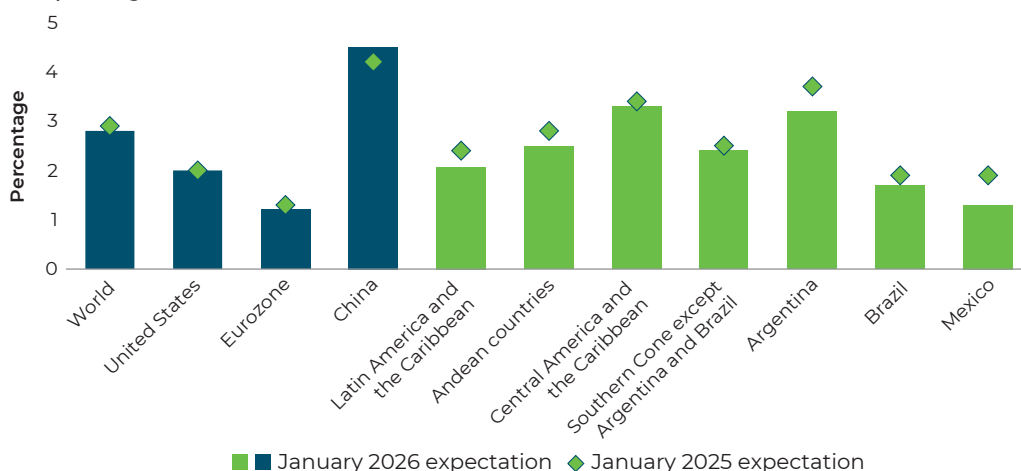
In this global environment, Latin America and the Caribbean is projected to grow by 2.2 percent in 2025 and 2.1 percent in 2026—close to its long-run average. Growth performance varies across the region's largest economies. Mexico has experienced the sharpest downward revision, with growth now expected at 0.5 percent in 2025, down from 1.2 percent projected in January 2025. By contrast, Argentina is rebounding strongly from recession, with growth projected at 4.3 percent in 2025, while Brazil's annual growth is expected to have normalized at around 2.3 percent after several years of robust, above-expectation expansion.

Beyond developments in the region's largest economies, some countries have been affected by highly specific sectoral and climatic shocks. Oil discoveries are driving rapid growth in Guyana¹ and are expected to boost activity in Suriname,² while extreme weather events have once again burdened Jamaica's economy, highlighting the region's worsening exposure to extreme weather events.³

¹ Guyana is projected to grow by 23 percent in 2026 (IMF 2025b).

² Suriname is projected to grow by 29 percent in 2028, when oil production is expected to commence (IMF 2025).

³ FocusEconomics revised Jamaica's 2025 growth forecast from 1.9 percent in October 2025 to 0.9 percent by January 2026 following the landfall of Hurricane Melissa.

FIGURE 1.1 • Global and Regional Growth Projections**A. Expected growth in 2025****B. Expected growth in 2026**

Source: Focus Economics Latin American Consensus Forecasts and IDB calculations.

Note: The panels report growth forecasts for 2025 and 2026, using the Latin Focus forecasts for January 2025 (diamonds) and January 2026 (bars). The country-group classification follows the IDB's regional departments, conditional on data availability in the source cited above. Southern Cone includes Argentina, Brazil, Chile, and Uruguay (both Brazil and Argentina are considered separately in the analysis); Central America and the Caribbean comprises of Belize, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama (Mexico is considered separately in the analysis, and there are no data available for the Bahamas, Barbados, Guyana, Haiti, and Suriname); and Andean countries include Bolivia, Colombia, Ecuador, Peru, and Venezuela. Percentages are averages weighted by GDP.

Over the long run, low productivity growth continues to constrain the region's prospects, a challenge made more binding as rapid demographic change increasingly limits labor-force expansion. Policies that promote greater competition,⁴ strengthen skills formation,⁵ deepen regional integration,⁶ and support the development of richer regional

⁴ See Alvarez et al. (2025).

⁵ See Busso et al. (2017).

⁶ See Mesquita Moreira and Stein (2019).

value chains⁷ have the potential to alter this trajectory and should remain at the forefront of the policy agenda. At the same time, persistent structural challenges will continue to call for strong policy responses, including adapting to demographic pressures that reduce the contribution of labor inputs, addressing low resilience to extreme weather events and the required transition toward lower emissions, and accelerating the adoption of emerging technologies.

As will be discussed in Chapter 2, rising global demand for critical minerals associated with the energy transition and digitalization offers a potential source of investment, exports, and productivity gains for parts of the region. Realizing these gains, however, will depend on complementary policies that strengthen institutions, infrastructure, and human capital, while ensuring resource wealth is translated into durable, productivity-led growth.

Moreover, even as these longer-term opportunities emerge, the region remains exposed to shifts in global financial conditions. Despite the resilience observed in Latin America and the Caribbean throughout 2025, a shift in global risk sentiment cannot be ruled out, as the challenges discussed in this report—particularly tight fiscal space—continue to weigh on the region. Such a shift would likely tighten financial conditions further, dampen capital flows, and put downward pressure on commodity prices, including those of key export products. As analyzed in Chapter 3, this could have significant implications for the region's growth outlook and fiscal position, especially for economies with weaker buffers and high commodity dependence.

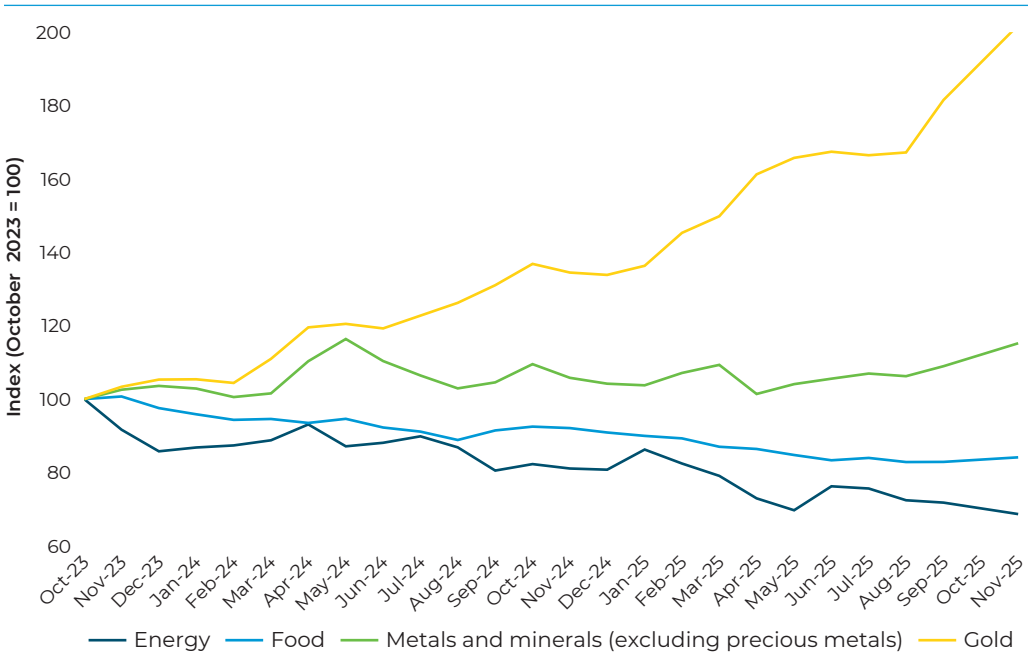
Commodities: A Double-Edged Sword

The current global economic environment has generated a divergent path for commodity prices, with important implications for Latin America and the Caribbean as one of the world's major commodity-producing regions (Figure 1.2). As a large share of the uncertainty and geopolitical tensions in 2025 originated in advanced economies—particularly the United States—many investors turned to gold rather than the U.S. dollar as a hedge, driving a sharp increase in its price, which in real terms doubled between October 2023 and November 2025. At the same time, accelerating digitalization and the rapid emergence of artificial intelligence have boosted demand for industrial metals, supporting the prices of minerals such as copper and opening a window of opportunity for a region richly endowed with these resources (see Chapter 2).

By contrast, moderate global growth prospects and increased oil supply from countries such as Brazil, Canada, Guyana, and the United States have affected energy prices, which tend to track closely with global economic activity. Historically, declines in the price of energy and other commodities have acted as an amplifying transmission channel for global shocks to the region, weakening fiscal revenues, external balances, and growth (see Chapter 3). In the current episode, however, price declines have so far been smaller

⁷ See Ayres, Izquierdo, and Parrado (2025).

FIGURE 1.2 • Commodity Prices



Source: Federal Reserve Economic Data (FRED), World Bank Commodity Price Data (The Pink Sheet), and IDB calculations.
Note: Nominal price series and nominal indices were deflated using the U.S. Consumer Price Index (CPI).

and less widespread, and the region has shown greater resilience, including among economies that rely more heavily on oil exports.

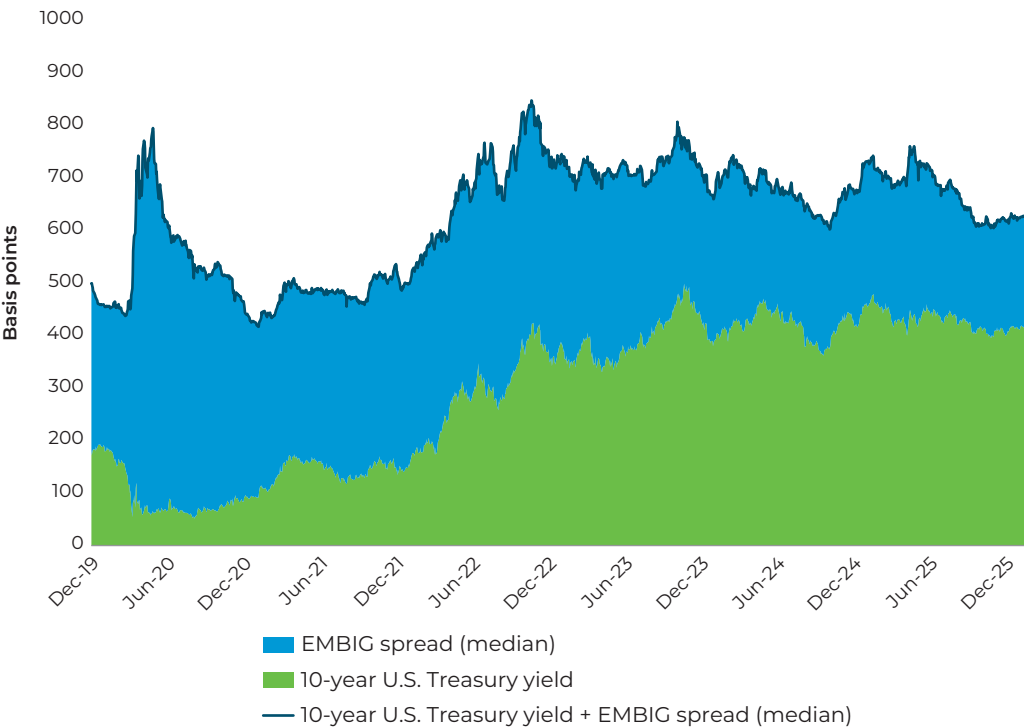
In summary, the current environment is characterized by diverging commodity trends. Whether these dynamics ultimately amplify volatility or support macroeconomic resilience and growth will depend on policy choices and institutional capacity. These are examined in detail throughout the report.

Resilience and Financial Conditions

The resilience of Latin America and the Caribbean reflects strong investor confidence, as evidenced by historically low sovereign spreads (Figure 1.3). The median sovereign spread in the region stood at 209 basis points at end of 2025, down from 268 in 2019. At the same time, countries that previously faced elevated risk premia—such as Argentina, Bolivia, and Ecuador—have recorded spreads below 700 basis points in recent months, levels not seen in many years.

Despite the contribution of lower spreads to the containment of financing costs, international financial conditions remain tight. Global interest rates have stayed elevated, particularly at longer maturities, reflecting heightened uncertainty, geopolitical tensions, and the substantial expansion of public debt worldwide—especially in advanced economies, where gross public debt is expected to reach roughly 120 percent of GDP by 2030 (IMF 2025b).

FIGURE 1.3 • Global Interest Rates and Latin American and Caribbean Sovereign Yield



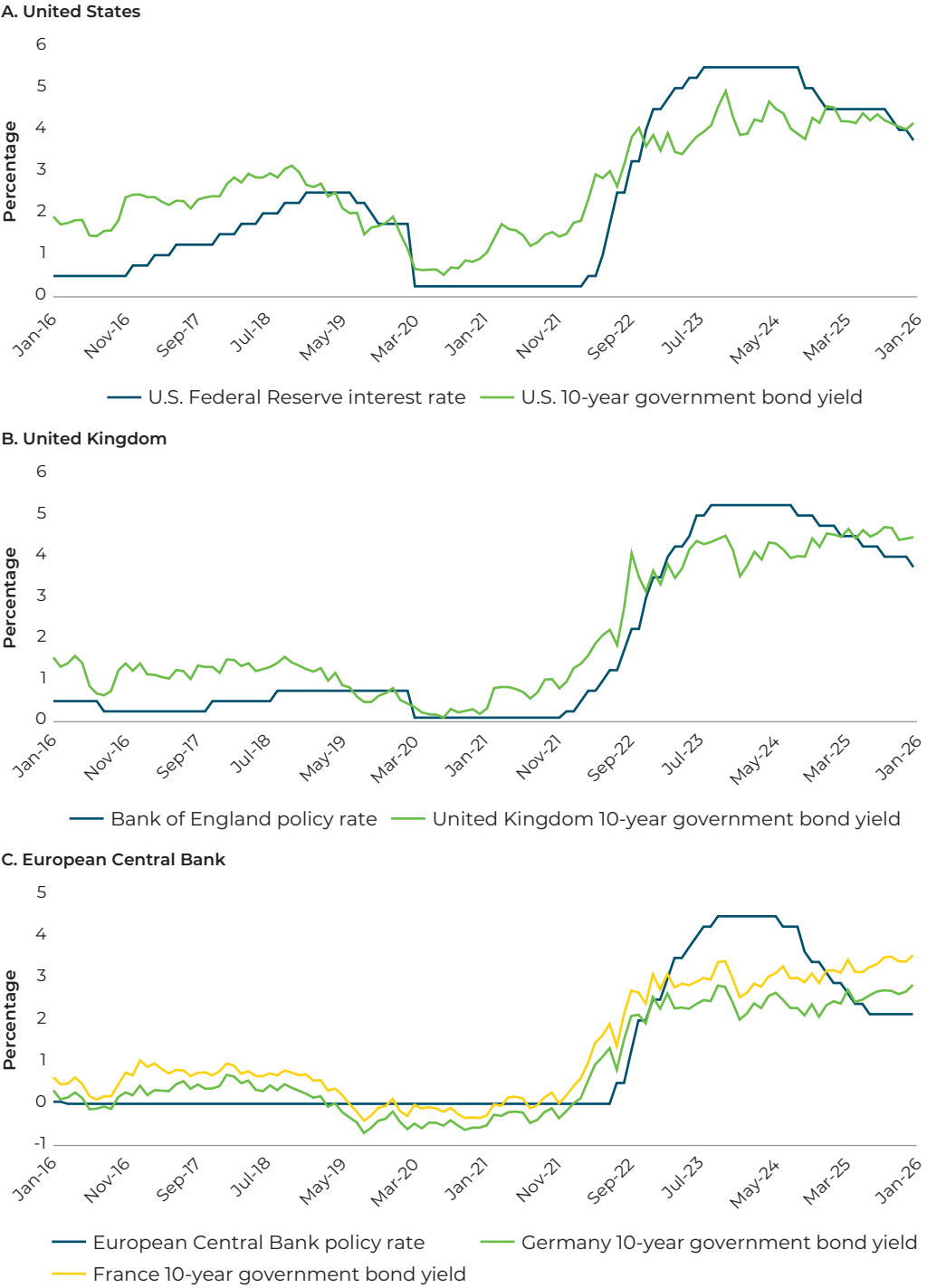
Source: Bloomberg and IDB calculations.

Note: Daily data from December 2019 to January 2026 from Bloomberg.

Under these conditions, although central banks found some room to lower policy rates through 2025, these reductions did not translate into lower long-term interest rates (Figure 1.4). In the euro area, for example, despite policy rate cuts by the European Central Bank from 4.5 percent in the first half of 2024 to 2.15 percent, yields on 10-year government bonds in countries such as France and Germany remained high, and in some cases increased.

This pattern is expected to persist into 2026. As a result, even further reductions in policy rates may fail to ease long-term financing conditions, and borrowing options for countries in Latin America and the Caribbean will continue to be constrained. As higher interest payments are increasingly weighing on public finances and external accounts, several countries are finding it more and more difficult to comply with fiscal rules, and pressures to relax fiscal frameworks and shorten debt maturities have intensified (see Chapter 4). Both responses would, however, ultimately undermine the region's resilience. Preserving credibility requires maintaining sound fiscal institutions while advancing structural reforms that support fiscal sustainability and productivity-led growth.

FIGURE 1.4 • Short versus Long-Term Interest Rates in Advanced Economies



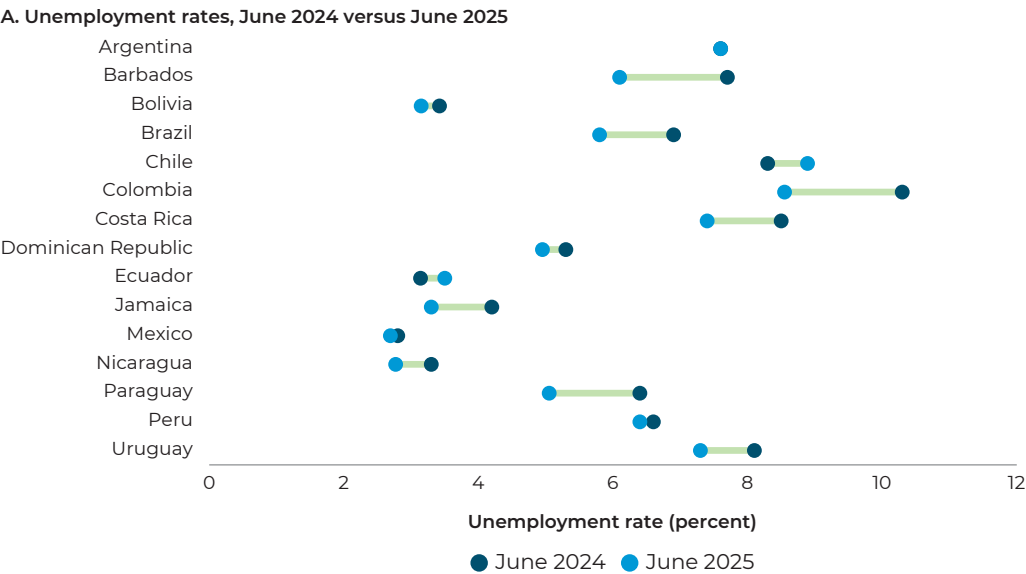
Source: Bloomberg.

Labor Markets

Labor market conditions across Latin America and the Caribbean improved notably in 2025. As shown in Figure 1.5, Panel A, unemployment rates fell in most countries between June 2024 and June 2025, bringing joblessness close to its lowest levels in recent years (Panel B).⁸ This improvement reflected both the post-pandemic growth and the resilience of labor markets in the region. Although the pace of formal job creation remains uneven across countries, the region has continued to absorb workers.

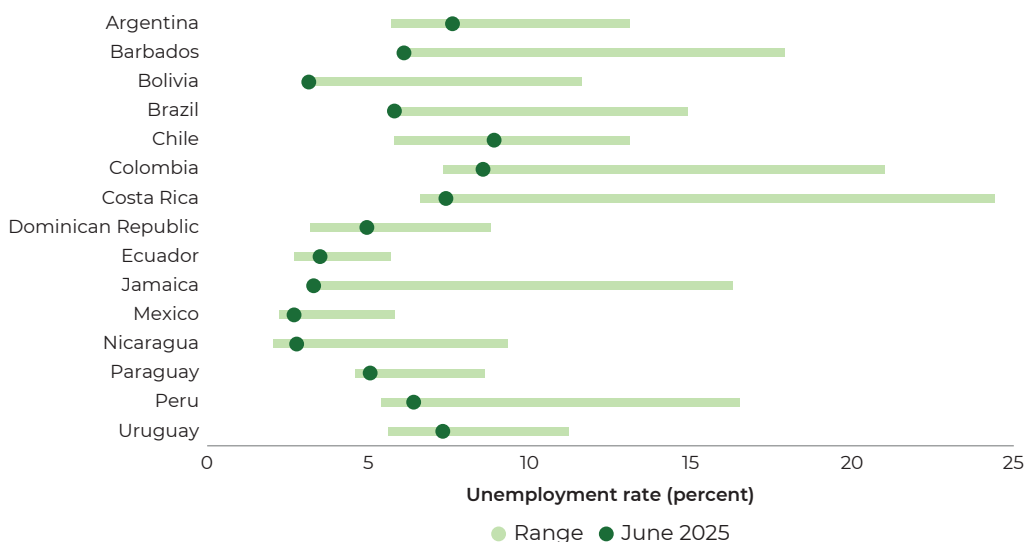
Despite these short-term gains, sustaining growth will be challenging because of long-term structural factors. Table 1.1, which decomposes the sources of growth, shows that labor accumulation has been a key driver of the region’s expansion for decades. In contrast, the contributions of capital deepening and total factor productivity (TFP) have been comparatively modest. This pattern implies that the region’s past growth model relied heavily on expanding labor input rather than sustained gains in productivity or investment, a strategy that is becoming increasingly constrained. The pattern contrasts sharply with that of advanced economies, where productivity growth has played a much larger role.

FIGURE 1.5 • Labor Markets



(continued on next page)

⁸ In a region with high levels of informality, changes in unemployment may be accompanied by changes in the share of informal jobs. See Aristizábal-Ramírez, Santos, and Torres (2025) for a discussion of these issues.

FIGURE 1.5 • Labor Markets *(continued)***B. Unemployment rates, June 2025 versus recent experience**

Source: IDB Labor Market Observatory, based on data from national statistics offices.

Note: For each country, the range reflects the minimum and maximum unemployment rates observed from the following start dates through June 2025: Argentina (March 2017); Barbados (March 2010); Bolivia (October 2015); Brazil (March 2012); Chile (March 2010); Colombia (January 2018); Costa Rica (September 2010); Dominican Republic (September 2014); Ecuador (June 2010); Jamaica (January 2011); Mexico (January 2010); Nicaragua (March 2015); Paraguay (March 2017); Peru (March 2010); and Uruguay (January 2010).

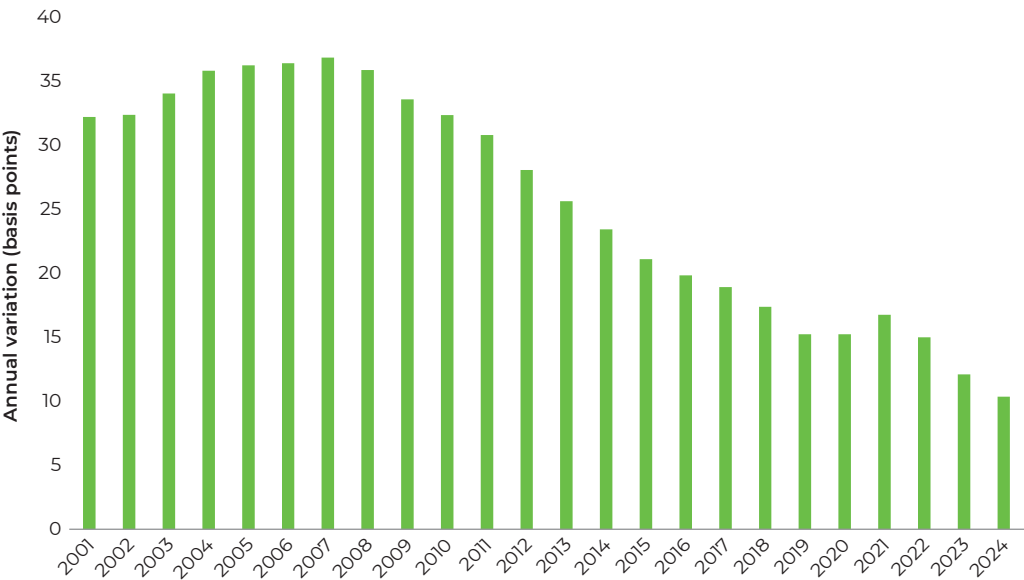
TABLE 1.1 • Growth Decomposition between 1960 and 2019

	Growth	Productivity	Capital	Schooling	Labor
(Values are expressed as percentages)					
Advanced economies	2.6	1.4	0.0	0.8	0.3
Emerging Asia	4.6	2.3	0.5	1.2	0.6
Latin America and Caribbean	1.8	0.1	0.1	1.0	0.6
Southern Cone	1.9	0.1	0.4	0.8	0.5
Andean countries	1.6	-0.1	-0.1	1.1	0.6
Caribbean	1.3	-0.6	0.6	0.9	0.4
Central America	2.1	0.5	-0.3	1.0	0.8

Source: IDB staff calculations, based on Penn World Tables version 10 data.

Note: The group of advanced economies includes Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Malta, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Taiwan, and the United Kingdom. Emerging Asia comprises China, Malaysia, the Republic of Korea, and Thailand. Latin America and the Caribbean includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, Guatemala, Jamaica, Mexico, Paraguay, Peru, Trinidad and Tobago, and Uruguay. It is further subdivided into four groups in line with the IDB's regional departments, conditional on data availability: Southern Cone (Argentina, Brazil, Chile, Paraguay, and Uruguay), Andean countries (Bolivia, Colombia, Ecuador, and Peru), Caribbean (Jamaica and Trinidad and Tobago), and Central America (Costa Rica, the Dominican Republic, Guatemala, and Mexico). All values are expressed as annual averages in percentage points. All countries are covered for the period 1960–2019 on a balanced panel.

FIGURE 1.6 ● **Working-Age People (15–64 Years Old) as Percentage of Total Population**



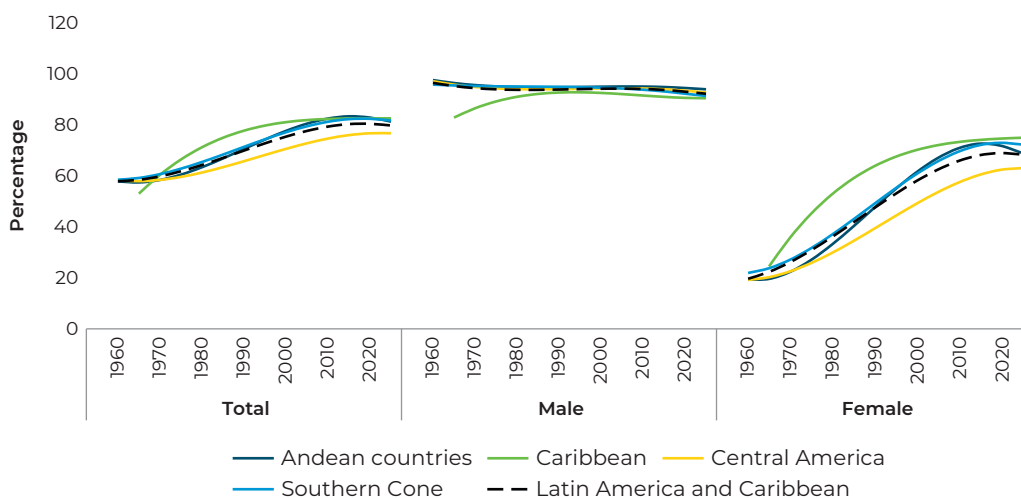
Source: Population estimates and projection (World Bank World Development Indicators) and World Economic Outlook (International Monetary Fund).

Note: The sample includes the simple average of the following countries: Argentina, Barbados, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Jamaica, Mexico, Nicaragua, Paraguay, Peru, and Uruguay. The data in the figure represent year-on-year (YoY) changes.

The scope for continued labor-driven growth is narrowing, however. As illustrated in Figure 1.6, the region’s working-age population is expanding more slowly than before, a reflection of the ongoing demographic transition from high fertility and mortality rates to lower ones. As birth rates fall and life expectancy rises, the share of the working-age population (15–64 years old) stops increasing and, eventually, declines. This demographic turning point implies that the natural supply of labor will no longer grow as fast, limiting the extent to which labor input can fuel economic growth.

The Role of Female Participation

The past rise in labor input was a matter not only of demographics but of participation. Much of the growth in the workforce during recent decades came from women entering the labor market. Figure 1.7 shows that female labor force participation surged, especially among prime-age women (25–54 years old), while that among men stagnated or even declined slightly. Yet this female momentum slowed in many countries and plateaued in others, leaving substantial gaps in participation between men and women.

FIGURE 1.7 • Labor Force Participation, by Sex

Source: ILOSTAT.

Note: The figure shows the employment-to-population ratio for the working-age population (25–54) by sex, smoothed using local polynomial regression. Values represent unweighted group averages across available countries in each year. This figure follows the IDB's regional department classification, conditional on data availability. Southern Cone includes Argentina, Brazil, Chile, Paraguay, and Uruguay. Andean countries include Bolivia, Colombia, Ecuador, Peru, and Venezuela. Caribbean includes Barbados, Jamaica, Suriname, and Trinidad and Tobago. Central America includes Belize, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Panama. Latin America and the Caribbean aggregates all four groups. The panel is unbalanced, with country coverage varying over time, depending on data availability. Country-level series are linearly interpolated prior to group aggregation to fill annual gaps.

Despite steady gains over the past decades, female labor force participation in Latin America and the Caribbean remains significantly below that of men and below levels observed in advanced economies. As demographic forces reduce the scope for labor-driven growth, higher female participation has become essential, not only for equity but to sustain aggregate productivity and mitigate pressures on public finances. Closing participation gaps would expand the effective labor supply, raise potential output, and strengthen the region's capacity to grow as demographic tailwinds fade.⁹

Persistent structural and social barriers continue to limit women's economic opportunities in Latin America and the Caribbean. A central constraint is the unequal distribution of unpaid care work, which disproportionately falls on women and forces many to trade off paid employment and family responsibilities (Araujo et al. 2024, chapter 5). Public policy can play a transformative role. Expanding access to affordable, high-quality early childhood education and child care is among the most effective ways to raise female labor force participation, particularly for mothers of young children. Complementary measures—such as nontransferable paternity leave, pay transparency, enforcement of equal pay legislation, and flexible work arrangements—can help shift social norms, reduce gender gaps, and support women's transitions into higher-productivity jobs (Araujo et al. 2024, chapters 5 and 9).

⁹ See Araujo et al. (2024).

Preparing Workers for a Changing Labor Market

The demographic trends summarized above directly limit the scope for labor-driven growth, as highlighted by the growth-accounting results. As the expansion of the working-age population slows and dependency ratios rise, the region's ability to rely on increases in labor input as a source of growth is diminishing. More and more, sustaining growth will depend on productivity gains and capital deepening, with improvements in total factor productivity hinging on workers' ability to adopt new technologies and move into higher-productivity tasks.

A key priority is helping workers adapt to the changing structure of labor demand. Firms across the region are posting fewer mid-skill vacancies while more often seeking workers with digital and analytical competencies, including those related to artificial intelligence. Policies that support skills development, expand access to digital training, and strengthen workers' ability to make transitions into emerging occupations can raise productivity and help economies adjust to this evolving landscape. These shifts in labor demand, and the opportunities they create, are discussed in Box 1.1. Ensuring that workers can adapt to these changes is essential to avoid skill mismatches in the labor market and to improve the allocation of talent, which in turn supports higher aggregate productivity.

BOX 1.1 • Labor Demand and Its Recent Transformation

New jobs in Latin America and the Caribbean are undergoing a transformation driven by evolving occupational requirements and the accelerating adoption of digital technologies, which will gradually reshape the composition of employment. Evidence from the *IDB Labor Market Observatory*—which has compiled more than 6.2 million online job vacancies across 15 countries between 2022 and 2025—shows a deceleration in hiring across the region. Vacancy volumes have fallen from their 2022 peak, particularly in occupations requiring medium and higher levels of preparation. These patterns indicate an adjustment in labor demand, with employers posting fewer mid-skill technical and administrative roles.

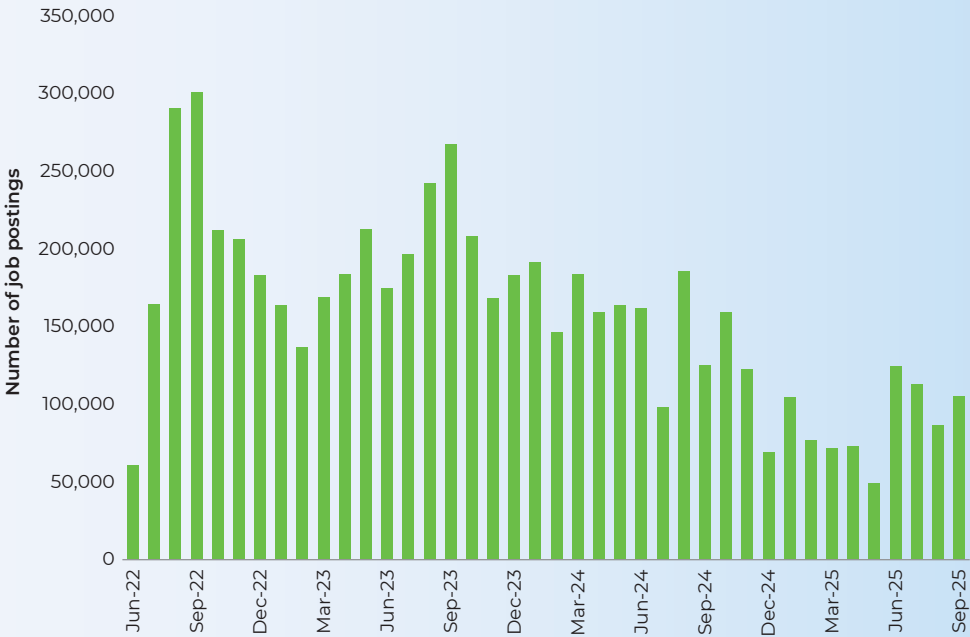
Throughout the region, traditional service-sector occupations continue to dominate labor demand. The most common postings are for executive assistants, retail sellers, financial sales agents, product promoters, and logistics support workers, reflecting the persistent importance of administrative and commercial services. Postings are concentrated in the large labor markets—those in Argentina, Brazil, Chile, Colombia, and Mexico—with their numbers driven by the labor markets' size and the maturity of their digital recruitment platforms.

Alongside these traditional patterns, the demand for workers with digital competencies is also robust. Knowledge-intensive industries—including professional services, finance, information, and education—regularly publish more vacancies requiring technical or analytical expertise. Across many countries, between 15 and 25 percent of vacancies explicitly call for digital skills, such as data analysis, software development, UX/UI, information systems, and cloud-based tools. These statistics illuminate the extent to which digitalization has become a prominent feature of the region's job market.

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BOX 1.1 • Labor Demand and Its Recent Transformation *(continued)*

FIGURE B1.1.1 • Total Published Job Postings



Source: IDB Labor Market Observatory.

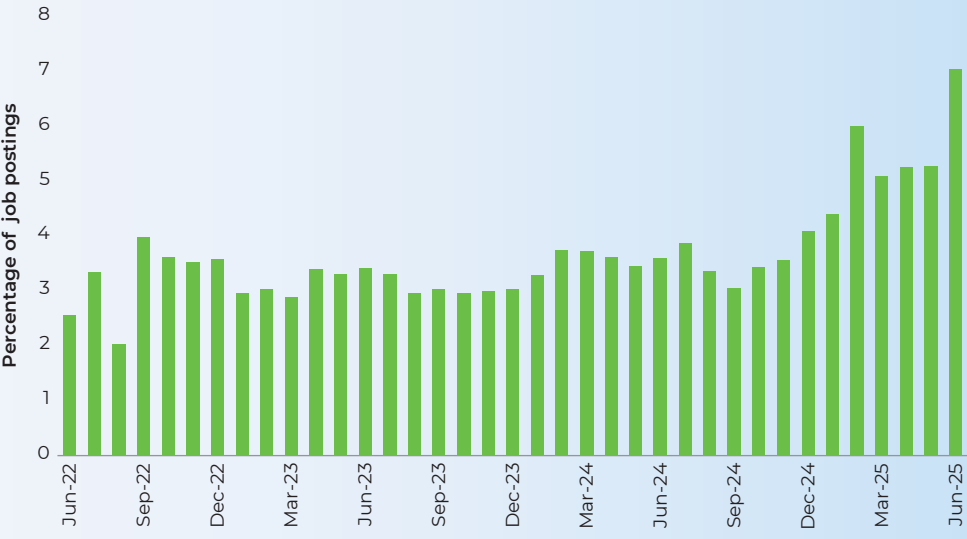
Within the broader digital transformation, artificial intelligence stands out as the fastest growing skill area. Vacancies referencing AI rose sharply in 2025, reaching 7 percent of all postings in June, the highest rate observed. AI-linked postings appear not only in technical fields, such as robotics, engineering, and data science, but in creative occupations, business analytics, and administrative roles, indicating the diffusion of AI tools across diverse segments of the labor market.

Overall, these trends point to a labor market undergoing a dual transition: While traditional service roles remain central to employment, the most dynamic growth is concentrated in digital and AI-intensive occupations. The increasing integration of digital and AI skills across sectors suggests that technological literacy is becoming essential for employability, productivity, and adaptation to evolving business models. Countries and firms that strengthen their capacity to develop and attract digitally skilled workers—especially those with AI capabilities—will be better positioned to capitalize on innovation and compete in a rapidly changing regional economy. These shifts in labor demand are, therefore, not just a labor market phenomenon; they are a central channel through which digitalization and AI can translate into productivity gains.

(continued on next page)

BOX 1.1 • Labor Demand and Its Recent Transformation *(continued)*

FIGURE B1.1.2 • Job Postings that Mention Knowledge of AI Technologies



Source: IDB Labor Market Observatory.

Overview of the Report

This report argues that Latin America and the Caribbean stands at a juncture where resilience has been preserved, but long-standing constraints on productivity and investment continue to limit growth. The outlook is shaped by three central forces that will define the region’s macroeconomic trajectory in the years ahead. First, the global push toward decarbonization, digitalization, and artificial intelligence has sharply increased demand for critical minerals, creating a window of opportunity for investment, exports, and productivity gains—conditional on institutions, infrastructure, and social governance that allow resource wealth to translate into durable growth. Second, macrofinancial conditions remain a central downside risk: Tighter global financial conditions, shifting risk sentiment, and the growing role of digital financial instruments—including foreign currency-indexed assets—shape capital flows, monetary policy effectiveness, and macroeconomic stability. Third, elevated interest costs and tighter financing conditions are increasingly constraining fiscal and external positions, placing renewed emphasis on policy credibility, buffers, and the quality of adjustment as determinants of resilience.

Taken together, these forces frame a common challenge: sustaining macroeconomic stability while reigniting productivity-driven growth in an environment of heightened global uncertainty. Opportunities linked to minerals, new technologies, and trade reconfiguration will not automatically translate into higher growth without complementary policies that strengthen competition, skills, fiscal frameworks, and institutions overall. At the same time, pressures on public finances, debt dynamics, and external balances mean that policies that weaken credibility or erode buffers could gradually undermine the resilience achieved in recent years.

The chapters that follow develop this argument in detail. Chapter 2 focuses on critical minerals as a potential source of investment, productivity gains, fiscal revenues, and strategic relevance. It argues that the global energy transition and digital transformation are reshaping demand for minerals, such as copper, lithium, and rare earths, of which the region holds significant endowments. At the same time, the chapter emphasizes that translating mineral wealth into durable development depends crucially on institutional quality, environmental governance, social license, and robust fiscal frameworks. Without these foundations, commodity cycles risk reinforcing volatility rather than supporting productivity-led growth.

Chapter 3 examines how shifts in global risk sentiment propagate to Latin America and the Caribbean through financial markets, exchange rates, and commodity prices. Using empirical and analytical tools, it shows that global risk-off episodes generate sizable and asymmetric effects across countries, with particularly strong impacts on commodity exporters and economies with weaker policy frameworks. The chapter highlights the central role of macrofinancial credibility, fiscal space, and exchange rate regimes in shaping resilience, demonstrating why preserving policy buffers remains essential even after a period of relative stability.

Chapter 4 turns to fiscal policy, assessing the region's limited fiscal space in an environment of persistently high global interest rates. It documents how rising debt service costs are increasingly constraining budgets, complicating consolidation efforts, and testing fiscal rules. The chapter discusses policy options to rebuild fiscal space, including strengthening fiscal frameworks, improving debt management strategies, and leveraging digitalization in tax administration. It also evaluates fiscal risks under adverse global scenarios, stressing the importance of strong institutions to prevent procyclical adjustment and safeguard resilience.

Chapter 5 analyzes the challenges monetary authorities must contend with following a successful disinflation. While inflation has largely returned to target in many countries, the chapter shows that higher global interest rates, shifting expectations, and the growing use of digital and foreign currency-denominated assets pose new challenges for monetary policy. It emphasizes the importance of anchoring expectations

and adapting policy frameworks to maintain monetary effectiveness in a changing financial landscape.

Finally, Chapter 6 examines the region's external accounts, documenting the return of current account deficits amid tighter global financing conditions and rising interest payments. It shows that while trade balances have improved in some cases, external pressures increasingly reflect income outflows and financing constraints. The chapter analyzes how countries have financed these deficits—through foreign direct investment, portfolio flows, official lending, and reserves—and identifies vulnerabilities associated with weaker buffers. It also discusses how deeper regional integration, diversification, and investment linked to critical minerals and new technologies could strengthen external resilience over the medium term.

Taken together, the report argues that Latin America and the Caribbean has entered this period of global uncertainty from a position of greater resilience than in past episodes. Preserving that resilience, however, will require sustained commitment to credible macroeconomic frameworks, the rebuilding of policy buffers, and the advancement of structural reforms that allow the region to harness new technological and commodity-driven opportunities while managing familiar external and fiscal pressures.

CHAPTER 2

Critical Minerals: A Window of Opportunity

Commodities have once again become central to macroeconomic debates in Latin America and the Caribbean. The ongoing energy transformation process and the rapid spread of modern technologies are reshaping the material foundations of the world economy. Minerals such as copper, graphite, lithium, nickel, and rare-earth elements have become essential to electrified transportation, renewable power, and digital infrastructure, assuming a strategic importance comparable to that of oil in the twentieth century.¹ Countries able to supply these minerals reliably and sustainably are becoming increasingly influential within global value chains.

For Latin America and the Caribbean, this shift presents a double-edged prospect. The region is richly endowed with many of the minerals needed for clean energy and digital systems, offering the potential for sustained investment, export growth, and fiscal revenues. Yet experience from past commodity booms in hydrocarbons, metals, and agriculture warns that natural wealth alone does not guarantee durable development. Growth spurts have often been short lived, spillovers limited, and productivity gains modest. Institutional quality, rather than geology, have proved decisive in whether resource abundance leads to long-run development and resilience or reinforces boom and bust cycles.

Furthermore, the opportunities arising from the higher demand for the region's natural resources will unfold within the broader macrofinancial landscape discussed in Chapter 1, one shaped by high uncertainty, volatile commodity prices, and potential changes in global sentiment toward risk. The region's ability to harness its mineral endowments will hinge not only on extraction and processing capacity but on strong macrofiscal institutions and policy frameworks capable of managing volatility and sustaining investment.

This chapter advances three arguments. First, critical minerals differ from conventional commodities; their criticality reflects both their indispensability to key technologies and supply risks, as shaped by technological, environmental, and geopolitical pressures. Second, the comparative advantage of Latin America and the Caribbean is large, but transforming it into lasting wealth is conditional on institutional and structural factors,

¹ Rare-earth elements are the 17 metals—including 15 lanthanides, plus scandium and yttrium—used in magnets, batteries, catalysts, and electronics. While not geologically scarce, they are rarely found in concentrated deposits, making extraction and processing complex and environmentally sensitive.

including infrastructure, access to energy and water, regulatory clarity, efficiency of permitting, and social license. Third, translating mineral wealth into productivity-led growth and macroeconomic stability requires moving beyond extraction by strengthening fiscal frameworks, improving environmental governance, and deepening regional integration to build richer regional value chains that provide the scale needed for both upstream and downstream development, while strategically linking selected activities to global value chains where the region holds durable advantages.

What Makes Minerals “Critical”?

The term *critical minerals* refers to materials that are both essential to important economic activities and subject to significant supply risk.² Countries maintain their own lists of such minerals, which are shaped by industrial structures and strategic priorities (Box 2.1). While these lists vary, they commonly include copper, graphite, lithium, nickel, and rare-earth elements. Demand for these materials has surged in recent years, largely as a result of structural changes in energy systems and the widespread adoption of new technologies. Electric vehicles, for instance, rely far more on mineral inputs than internal combustion cars, and wind and solar installations require substantially larger quantities of metals than fossil fuel plants.

BOX 2.1 • What Makes a Mineral Critical? A Historical and Technical Primer

The concept of critical minerals has altered markedly, from mid-twentieth-century lists of strategic wartime materials to the data-driven assessments used by geological surveys and industrial policy agencies today. Earlier classifications emphasized minerals essential to national defense. As global value chains expanded and high-tech industries grew, definitions broadened to include minerals vital to civilian sectors—semiconductors, telecommunications, and clean energy—where supply disruptions could impose significant economic and social costs. Because industrial structures differ, so do national lists; at present, the United States designates fifty critical minerals, while the European Union identifies thirty-four.

Over the past decade, driven by the energy transformation process and rapid digitalization, demand for many of these materials has surged. Electric vehicles require lithium, nickel, cobalt, and graphite for batteries, while copper and aluminum are fundamental to wiring and motors. Rare-earth elements make possible the permanent magnets used in electric vehicles and wind turbines, and the expansion of solar power increases the demand for copper, silver, and specialized alloys. Digital technologies—from microelectronics to defense systems—depend on gallium, germanium, and rare earths. With limited substitutes, modest recycling rates, and long development timelines, supply has often struggled to keep pace.

Modern frameworks define criticality through two dimensions: economic importance and supply risk. The U.S. Geological Survey assesses such factors as production concentration,

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² See National Research Council (2008) and Graedel et al. (2015).

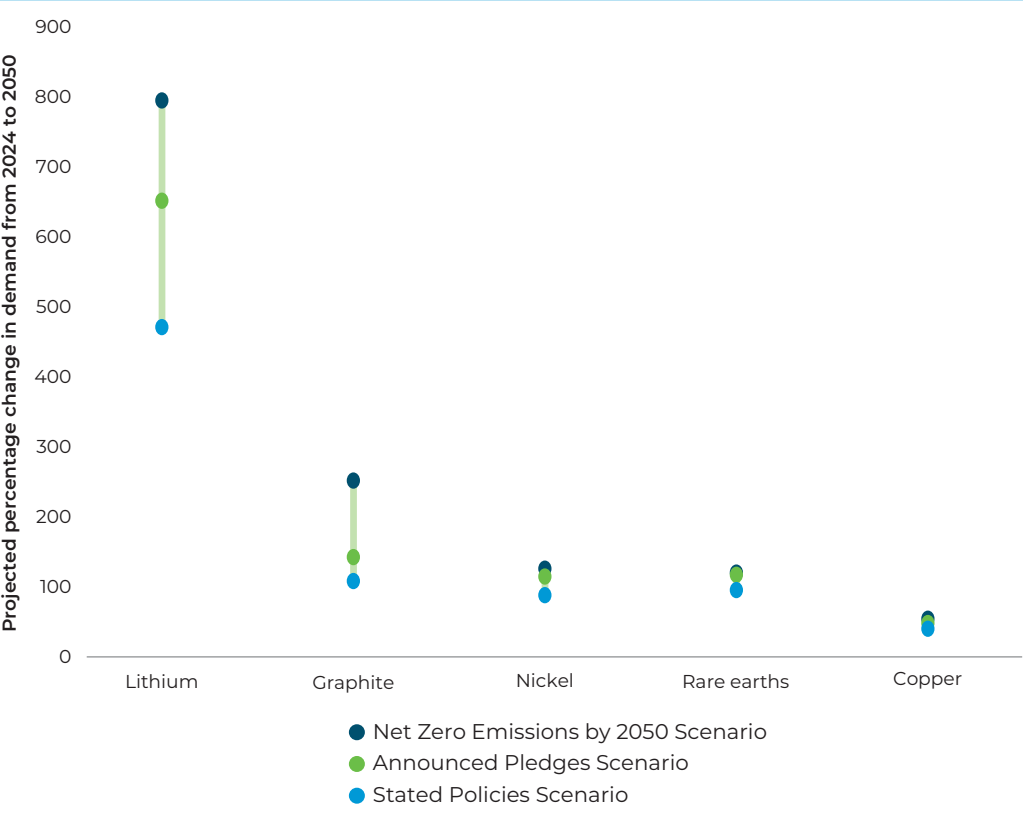
BOX 2.1 • What Makes a Mineral Critical? A Historical and Technical Primer
(continued)

import reliance, byproduct dependence, recycling, substitutability, and geopolitical exposure. The European Commission uses input-output analysis to gauge economic importance and evaluates supply risk based on concentration and the quality of governance in supplier countries. Earlier approaches, including those of the British Geological Survey and Japan's Ministry of Economy, Trade and Industry (METI), similarly emphasized vulnerability and stockpiling needs.

From this short primer, several insights emerge. First, criticality is dynamic; lists evolve as technologies change, including innovations in battery chemistry that influence the role of cobalt or nickel. Second, critical does not mean rare; copper is widely produced yet systemically important. Finally, stockpiling and recycling can moderate short-term risks but cannot fully offset constraints in rapidly growing sectors.

In sum, critical minerals are those that combine high economic importance with significant supply risk. This explains why copper, graphite, lithium, nickel, and rare earths anchor most contemporary lists and why classifications continue to evolve with technology and geopolitics.

FIGURE 2.1 • Projected Variation in Demand for Selected Critical Minerals

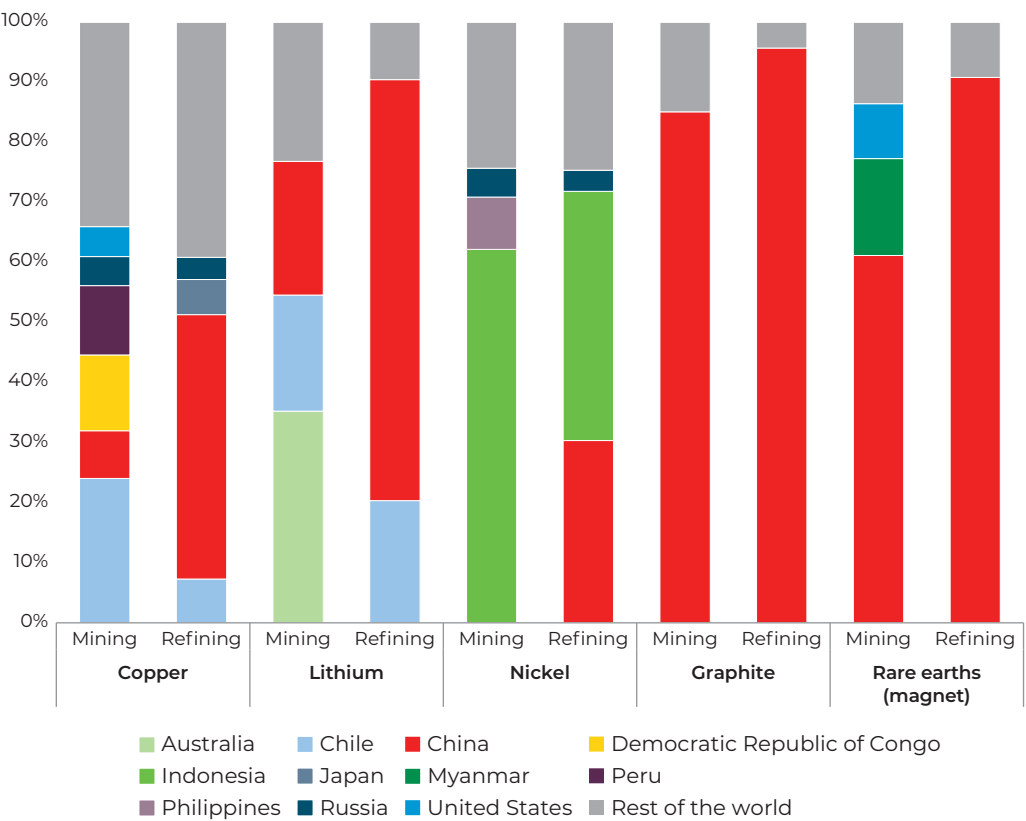


Source: International Energy Agency (IEA).
Note: Demand refers to the projected volume of minerals (measured in metric tons of contained material), rather than their monetary value. In the figure, the dots are sorted in descending order of projected demand growth under the Net Zero Emissions by 2050 Scenario.

While demand for critical minerals is expected to remain strong, projections vary widely (Figure 2.1). The global demand for lithium, for example, is projected to rise between 470 and 800 percent by 2050, depending on whether climate policies follow current commitments or move to more ambitious trajectories.³ Technological change will also shape outcomes; advances in battery chemistry, recycling, and alternative materials could alter the composition of future demand even as overall consumption continues to grow (International Energy Agency 2024).

Supply, meanwhile, is highly concentrated (Figure 2.2). China dominates both the production and, especially, the refining and processing of rare earths and graphite, while global nickel output comes mainly from a small group of countries headed by Indonesia.

FIGURE 2.2 • Global Supply Concentration of Selected Critical Minerals



Source: International Energy Agency (IEA).

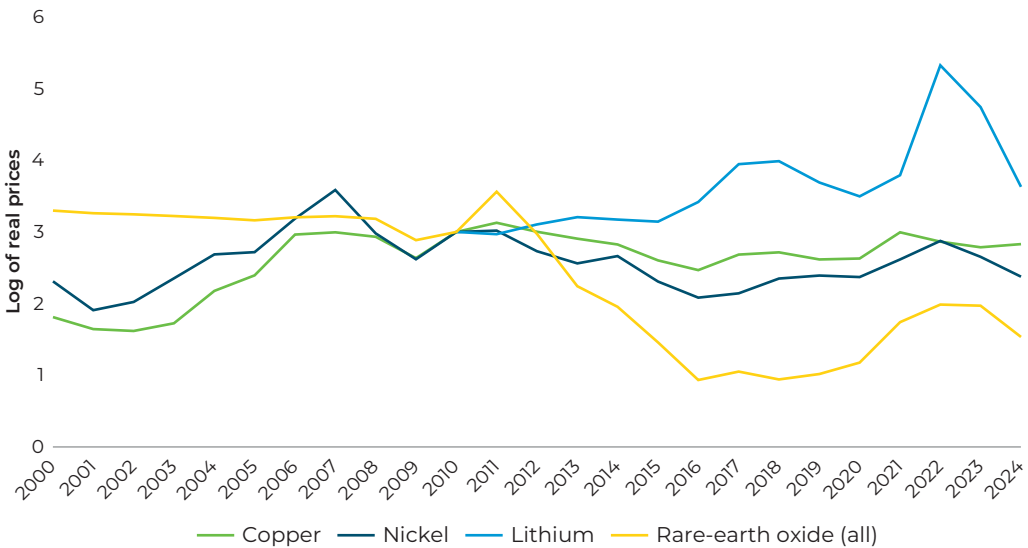
³ The International Energy Agency (IEA) assesses future energy and emissions trends according to three main scenarios. The Stated Policies Scenario reflects measures already in place; the Announced Pledges Scenario assumes all national climate pledges are met on time; and the Net Zero Emissions by 2050 Scenario outlines a normative pathway consistent with limiting global warming to about 1.5°C.

Such concentration increases the vulnerability of global value chains to geopolitical and logistical shocks and pushes buyers to diversify sourcing toward jurisdictions able to deliver large amounts of minerals while adhering to rigorous environmental and social standards (Nassar, Graedel, and Harper 2015; International Energy Agency 2025).

The uneven race between demand and supply has generated pronounced boom-and-bust cycles (Figure 2.3), a pattern exacerbated by the absence of centralized markets and benchmark prices for several critical minerals, which increases uncertainty and magnifies swings in expectations. Lithium prices, for instance, surged in 2017–18 and again in 2021–22, before retreating as new production started up. Policy actions have also played a role. The 2010–11 surge in the price of rare earths, for example, was partially the result of Chinese export restrictions, which constrained global supply and led to stockpiling (Humphries 2013; Mancheri 2016).⁴ Ultimately, even those minerals central to modern technologies remain commodities subject to cyclical price swings and changes in global risk sentiments (see Chapter 3).

Looking ahead, these dynamics are likely to persist. Demand for critical minerals will continue to expand, while supply growth will remain constrained by regulatory delays, technical complexity, environmental limits, and other factors discussed later in this chapter.

FIGURE 2.3 • Price Trends of Selected Critical Minerals



Source: Federal Reserve Economic Data (FRED), U.S. Geological Survey (USGS), World Bank Commodity Price Data (The Pink Sheet), and IDB calculations.

Note: Nominal price series were deflated using the U.S. Consumer Price Index (CPI). Series are normalized such that the log of the real prices is equal to 3 in 2010. Commodity price series are based on World Bank Commodity Price Data (The Pink Sheet), except for lithium and rare-earth oxide, whose price series are from the USGS.

⁴ Alfaro et al. (2025) show that China's rare-earth export restrictions spurred innovation and export growth in downstream sectors outside of China.

The Region’s Endowments and Practical Economics of Production

Latin America and the Caribbean is richly endowed with minerals essential to the energy and digital transformations (Table 2.1). The subsoil of the Andes and the Brazilian Shield contain abundant reserves of copper, lithium, nickel, graphite, and rare-earth elements. A simple valuation—multiplying the size of known reserves by current international prices—illustrates the scale of these assets, as shown in Figure 2.4. In Brazil, for example, the estimated value of rare-earth reserves amounts to roughly twice the country’s GDP (Figure 2.4, Panel C).⁵

TABLE 2.1 • Critical Minerals in Latin America and the Caribbean

Mineral	Latin American production leaders and potential producers	Main uses
Aluminum (including bauxite)	Brazil, Guyana, Jamaica, Suriname, Venezuela	Almost all sectors of the economy
Antimony	Bolivia, Mexico	Lead-acid batteries and flame retardants
Arsenic	Peru	Semiconductors
Barite	Mexico	Oil and gas drilling and medical imaging
Beryllium	Brazil (potential)	Manufacture of metal alloys for aerospace and defense
Bismuth	Bolivia (potential), Mexico (potential)	Nontoxic metals, atomic research, and some medical applications
Boron (including borates)	Argentina, Bolivia, Chile, Peru	Hardening of steel and glass and in nuclear energy
Rare earths (excluding scandium)	Brazil (potential)	Batteries, permanent magnets, lasers, catalysts, metallurgy, nuclear reactor components, fiber optics, data storage devices, medical imaging, electronics, and some cancer therapies, aerospace metal alloys, ceramics, and colorants
Cesium	Chile (potential)	Atomic clocks for global positioning systems
Chromium	Brazil	Stainless steel
Cobalt	Brazil (potential)	Batteries and metal alloys used in extreme temperatures
Copper	Argentina, Chile, Mexico, Panama (potential), Peru	Wiring and cables
Fluorspar	Mexico	Synthetic materials and plastics, iron and steel, ceramics, glass, and refineries

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⁵ Although substantial, these values remain far below those associated with the oil reserves of Guyana and Suriname, which are driving major economic booms. Using the same valuation method, their reserves amount to roughly 35 and 42 times their GDPs, respectively.

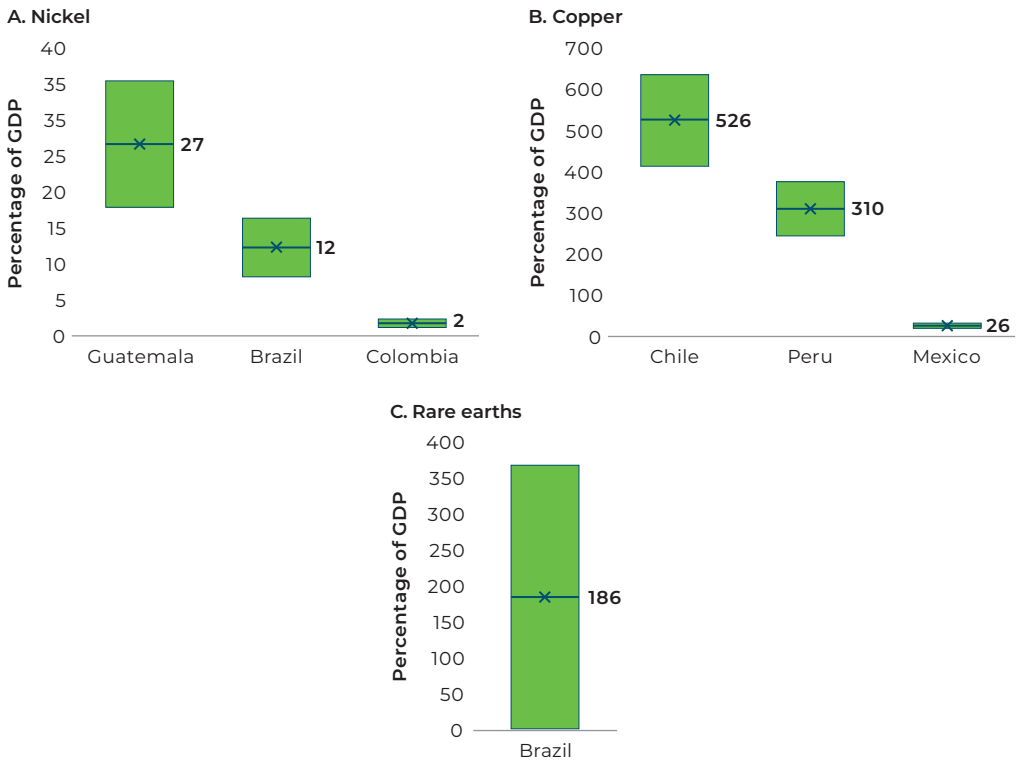
TABLE 2.1 • Critical Minerals in Latin America and the Caribbean *(continued)*

Mineral	Latin American production leaders and potential producers	Main uses
Graphite	Brazil, Mexico	Lubricants, batteries, and fuel cells
Indium	Peru (potential)	Flat-panel displays and touchscreens
Lead	Bolivia, Mexico, Peru	Batteries, ammunition, and glass and ceramics production
Lithium	Argentina, Bolivia (potential), Brazil (potential), Chile, Mexico (potential), Peru (potential)	Rechargeable batteries
Magnesium	Brazil	Metal alloys used by aerospace, automotive, and electronics industries
Manganese	Brazil, Mexico	Steel production and batteries
Nickel	Brazil, Colombia, Dominican Republic, Guatemala	High-strength steel and rechargeable batteries
Niobium	Brazil	Strengthening of steel
Phosphate	Brazil, Mexico, Peru	Fertilizers
Potash	Brazil, Chile	Fertilizers
Rhenium	Chile, Peru	High-performance jet engines and gas turbines
Rubidium	Peru (potential)	Atomic clocks for global positioning systems, data network syncing, and research and development
Silicon	Brazil, Venezuela (potential)	Silicon wafers fundamental to semiconductors
Silver	Argentina, Bolivia, Chile, Mexico, Peru	Electrical circuits, batteries, solar cells, and antibacterial medical instruments
Tantalum	Bolivia (potential), Brazil	Materials and electronic components that need to withstand high temperatures and harsh environments
Tin	Bolivia, Brazil, Peru	Food and beverage cans, circuit board components, and corrosion-resistant metal coatings
Titanium	Mexico (potential, mainly through the titanium dioxide pigment sector)	White pigment and in metal alloys, including for airplanes, spacecraft, and military vehicle armor
Tungsten	Bolivia	Wear-resistant metals for jet engines, ammunition, and mining and cutting equipment
Uranium	Brazil (potential)	Nuclear fuel and medical applications
Vanadium	Brazil	Strengthening of iron and steel
Zinc	Bolivia, Mexico, Peru	Coating to protect iron and steel from rust and corrosion

Source: U.S. Geological Survey (USGS) and U.S. Department of the Interior.

Note: The table shows a selected subset of critical minerals based on the U.S. Department of the Interior list (available through the USGS) and a European list of critical raw minerals.

FIGURE 2.4 • Value of Reserves of Selected Critical Minerals Relative to GDP

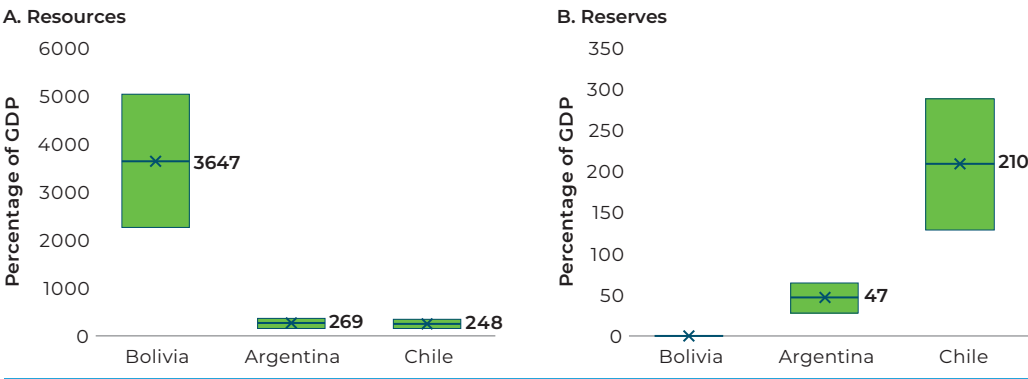


Source: IMF (2025b), U.S. Geological Survey (USGS), World Bank Commodity Price Data (The Pink Sheet), and IDB calculations.

Note: The value is calculated as the size of reserves in metric tons, multiplied by the nominal price per metric ton in U.S. dollars and divided by the respective country's GDP, also in U.S. dollars, using 2024 values. To reflect price volatility, the figure also reports the valuation using the average 2024 price plus and minus one standard deviation of the respective critical mineral price series between 2010 and 2019 (the bars), in which the U.S. GDP deflator is used to normalize prices.

These figures are purely illustrative, however, since they are based on the assumption that all reserves could be extracted and commercialized immediately. In reality, extraction unfolds over long time horizons and requires substantial technical and financial effort within established regulatory and permitting frameworks—hence, the distinction between *resources* and *reserves*. While mineral resources reflect geological concentrations with extraction potential, reserves are the subset proved to be economically recoverable under current prices and regulations, using currently available technology (Wallace 1991). For comparison, Figure 2.5 reports the value of both resources and reserves for lithium. A notable feature is that Bolivia, despite having much larger lithium resources than Argentina and Chile, has far smaller reserves. This reflects the fact that much of Bolivia's lithium has not yet been demonstrated to be economically viable—even though its estimated value could reach up to about 40 times the country's GDP.

FIGURE 2.5 • Lithium Resources and Reserves as a Percentage of GDP



Source: IMF (2025b), U.S. Geological Survey (USGS), and IDB calculations.
Note: The value is calculated as the size of resources (Panel A) and reserves (Panel B) in metric tons, multiplied by the nominal price per metric ton in U.S. dollars and divided by the respective country's GDP, also in U.S. dollars, using 2024 values. To reflect price volatility, the figure also reports the valuation using the average 2024 price, plus and minus one standard deviation of the respective critical mineral price series between 2010 and 2019 (the bars), in which the U.S. GDP deflator is used to normalize prices.

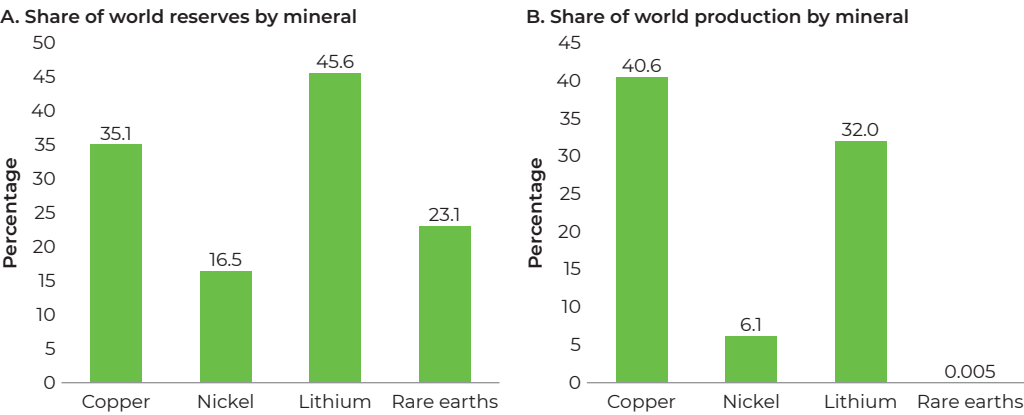
A Unique Geological Landscape

The geographical distribution of critical minerals across Latin America and the Caribbean is uneven. Copper remains the flagship mineral, with Chile and Peru together supplying an estimated 40 percent of global output, in line with their combined share of about 35 percent of identified global reserves (Figure 2.6). The region is also home to the world's largest lithium resources; the so-called lithium triangle of Argentina, Bolivia, and Chile contains half of global resources. Latin America and the Caribbean holds, in addition, around 16 percent of global reserves of nickel and 23 percent of rare earths.

Just as not all resources qualify as reserves, however, large reserves do not automatically translate into production. In fact, despite having significant rare-earth reserves, Latin America and the Caribbean produces only about 0.005 percent of global supply. While this suggests considerable opportunity for the region, realizing that opportunity is far from assured. Turning potential into viable, sustainable production requires overcoming the interconnected technical, infrastructural, environmental, institutional, and social challenges that ultimately shape competitiveness and long-term development—often demanding regional integration to achieve scale and coordinated strategies to develop upstream, downstream, and related service activities.⁶

⁶ See Andrian et al. (2023) and Parés Olguín and Busch (2024).

FIGURE 2.6 • Latin American and Caribbean Share of World Mineral Reserves and Production



Source: British Geological Survey (BGS) and U.S. Geological Survey (USGS).

Operational Bottlenecks and Technological Constraints

Mineral extraction in Latin America and the Caribbean is becoming increasingly complex, costly, and technologically demanding. For established producers such as Chile and Peru, declining ore grades require the processing of much larger volumes of rock, which increases in turn the consumption of energy, water, and chemicals. Automation and ore-sorting technologies that have improved efficiency only partially offset rising marginal costs and longer project timelines (International Energy Agency 2025).

Production is further complicated by geography. Many of the region’s most promising mineral deposits lie in remote, poorly connected areas. Inadequate transportation and energy infrastructure prolongs construction, discourages investment, and accentuates the need for improved roads, railways, and cross-border corridors to link deposits to global supply chains.

Another binding constraint for critical minerals development is energy availability. Mining and processing are highly energy intensive, and dependence on imported fossil fuels exposes producers to price volatility and cost spikes. The adoption of expanding technologies, such as solar and wind, can stabilize costs while reducing the emissions from production. The ability to generate abundant, reliable, low-emission electricity for extraction and processing could become a major source of comparative advantage for Latin America and the Caribbean, especially as importing countries tighten sustainability standards and increasingly differentiate supply chains based on environmental performance.

Finally, in emerging sectors such as lithium and nickel, the main bottleneck is technological capability. Scaling up production requires stronger laboratory capacity and process engineering skills and a more sophisticated network of specialized suppliers. In these

respects, much of the region lags. Catching up will require coordinated investment in research and technical training and collaboration between industry and academia.

Managing Environmental Risks for Sustainable Mining

Mining is highly resource intensive, and many of Latin America's major mineral regions lie in environmentally fragile zones. In the lithium triangle, the use of brine extraction⁷ raises concerns about aquifer depletion, while large copper and gold operations generate substantial tailings—that is, waste materials—that must be managed to prevent contamination.

Although the Global Industry Standard on Tailings Management, launched in 2020, has strengthened safety practices, it has also increased compliance costs (ICMM, UNEP, and PRI 2020). Strong, predictable regulators capable of transparent assessment and consistent enforcement are, therefore, essential, not only to protect ecosystems but also to maintain investor confidence. Regulating performance outcomes rather than prescribing extraction methods encourages innovation and flexibility (Gobierno de Chile 2023; International Energy Agency 2024), and regulatory frameworks across the region are presently evolving toward technology-neutral rules that set targets for water use, recovery rates, and carbon intensity.

Despite these advances, environmental pressure related to the extraction of critical minerals remains significant. Globally, environmental transparency is increasingly required for market access. The European Union's Carbon Border Adjustment Mechanism (2023) links trade preferences to verified emissions and responsible sourcing, making measurement, reporting, and verification (MRV) systems essential for producers. In Latin American and Caribbean countries, however, enforcement capacity, data transparency, and inter-agency coordination are uneven. It will be important to move beyond project-level reviews toward basin-level governance capable of monitoring cumulative impacts and allocating water sustainably (Rojas-Hayes, Casas, and Sucre 2023).

Institutions and Regulations as Competitive Assets

Across the region, slow and fragmented licensing systems are major constraints on the extraction of critical minerals, with overlapping agencies, the absence of one-stop permitting systems,⁸ and a lack of clear statutory timelines leading to uncertainty and lengthy

⁷ Brines are saline solutions found beneath salt flats that contain dissolved minerals such as lithium and potassium. They are pumped to the surface and processed through evaporation or chemical extraction to recover these elements.

⁸ A one-stop permitting system consolidates the permitting process into a single platform to make approvals faster, clearer, and more transparent.

delays (Andrián et al. 2023; OECD 2016a, 2016b). Introducing coordinated, time-bounded permitting could streamline approvals without weakening environmental safeguards. Equally important as efficiency and speed is regulatory stability. Frequent renegotiation of contracts and fiscal terms undermines credibility and deters long-term investment, whereas embedding stability clauses and fiscal rules in law increases investor certainty (Manzano, Navajas, and Powell 2017).

Strengthening monitoring and enforcement is also essential, as both environmental performance and investor confidence are undermined by underresourced and politicized agencies that struggle to apply rules consistently. Regional coordination can reduce regulatory fragmentation, while compliance costs could be lowered by harmonizing environmental, social, and governance (ESG) standards within blocs such as MERCOSUR (the Southern Common Market) or the Lithium Triangle. Shared certification and MRV systems could prevent a “race to the bottom,” in which countries weaken their standards to attract investors.

Earning Social License

Mining projects in Latin America and the Caribbean often take place in remote indigenous or rural areas characterized by historical exclusion, weak state presence, and low trust in institutions. In such contexts, social opposition is rarely driven solely by project-specific environmental or economic impacts. Instead, resistance reflects broader narratives about governance quality, fairness, and control over natural resources. When consultation processes are perceived as procedural rather than substantive, or when benefits are viewed as unevenly distributed, opposition can escalate rapidly.

Latin America and the Caribbean stands out for the intensity and persistence of mining-related social conflict. Globally, the region accounts for a disproportionate share of disputes over mineral extraction, which are more likely to lead to prolonged project delays, suspensions, or cancellations (Balza et al. 2024). These conflicts impose large economic costs through construction holdups, cost overruns, and foregone investment, effectively transforming social risk into a material constraint on project viability (Franks et al. 2014). As a result, social legitimacy has become as decisive for mining outcomes as geology, prices, or access to finance (Balza et al. 2023b). The acceptance of projects depends more on who governs them, how decisions are made, and whether benefits are perceived as fair and locally visible. Conflicts reflect not only economic concerns but issues of identity, procedural and distributive justice, and trust in public institutions (Ajzenman et al. 2023).

Beyond local dynamics, societal social license—the approval granted to particular activities by society at large—plays a central role. Evidence from 12 Latin American and Caribbean countries shows that national narratives shaped by institutional performance and enforcement capacity strongly influence the acceptance of extractive activities

(Balza et al. 2023a, 2024). Where governance is perceived as weak, opposition intensifies, increasing the likelihood of escalation, delays, and disruption (Balza et al. 2023b).

Building social license requires early, continuous, and genuine engagement embedded in governance structures. Transparent benefit sharing, high-quality consultation, and accessible grievance mechanisms reduce disruptions and shorten development timelines (Andrián et al. 2023). Formal community agreements, predictable royalty rules, and independent grievance systems help institutionalize legitimacy, making social license a first-order determinant of whether the region's mineral potential can translate into timely and reliable supply (OECD 2016a; United Nations 2011).

From Extraction to Development: Guarding Against the Resource Curse

History shows that transforming geological abundance into lasting prosperity is a challenge. Many resource-rich countries have performed worse than their resource-poorer peers, giving rise to the term *resource curse*.⁹ This can happen in several ways. Resource wealth may weaken incentives for institutional development and instead encourage rent seeking and corruption, ultimately undermining social, political, and economic stability, and¹⁰ revenue windfalls can spur overborrowing and procyclical spending, heightening the risk of default.¹¹ In addition, the expansion of the resource sector can appreciate the real exchange rate and draw labor and capital away from other tradable activities, which become less competitive globally. This reallocation can weaken sectors that generate stronger linkages and productivity spillovers—a dynamic commonly referred to as “Dutch disease.”¹²

From Efficient Extraction to Strategic Upgrading

Lasting gains from mineral abundance begin with an extractive sector that is efficient, competitive, and environmentally responsible. Whether led by public or private actors, production models must remain flexible and adaptive as technologies and environmental standards evolve. But high productivity at the mine site is only the first step. To translate mineral wealth into broader development, countries must connect these efficient extractive activities to the rest of the economy.

For over a century, Latin America and the Caribbean has specialized in extraction, with most processing and manufacturing carried out abroad (see Box 2.2). Today's

⁹ See Auty (2002) and Humphreys, Sachs, and Stiglitz (2007).

¹⁰ See Robinson, Torvik, and Verdier (2006).

¹¹ See Manzano and Rigobon (2001), Esquivel (2025), and Hamann, Mendoza, and Restrepo-Echavarria (2023).

¹² *Dutch disease* refers to the loss of competitiveness in nonresource sectors caused by real-exchange-rate appreciation following a resource boom. The term was coined by *The Economist* in 1977 and formally analyzed by Corden and Neary (1982).

reconfiguration of global supply chains—driven by nearshoring (that is, the outsourcing of processes to companies in nearby countries), security-of-supply concerns, and low-carbon production—creates selective opportunities to retain more value at home. Success, however, depends less on protectionism than on creating an enabling ecosystem where scale, logistics, clean energy, and strong institutions intersect.

Regional integration can play a central role in this process. By expanding market size, it can provide the scale needed to develop upstream and downstream industries and more sophisticated regional value chains. Regional research and development platforms and shared geological data systems—such as Geoscience Australia, which underpins Australia’s Critical Minerals Strategy through coordinated mapping, data infrastructure, and research partnerships, and the European Raw Materials Alliance (ERMA), which pools regional data and supports pilot and demonstration projects—show how coordinated institutions can accelerate technological learning and reduce dependence on imported know-how (Commonwealth of Australia 2023; ERMA 2021).

BOX 2.2 • The Global Value Chain of Critical Minerals

Understanding how countries are positioned in global trade—both as suppliers and demand hubs—is essential to assessing exposure, leverage, and risk across mineral value chains. This network-based analysis explores two core dimensions of global trade positioning: “upstreamness”—how early or late a country’s exports enter into the production process—and trade centrality, which captures how structurally embedded a country is in global flows.

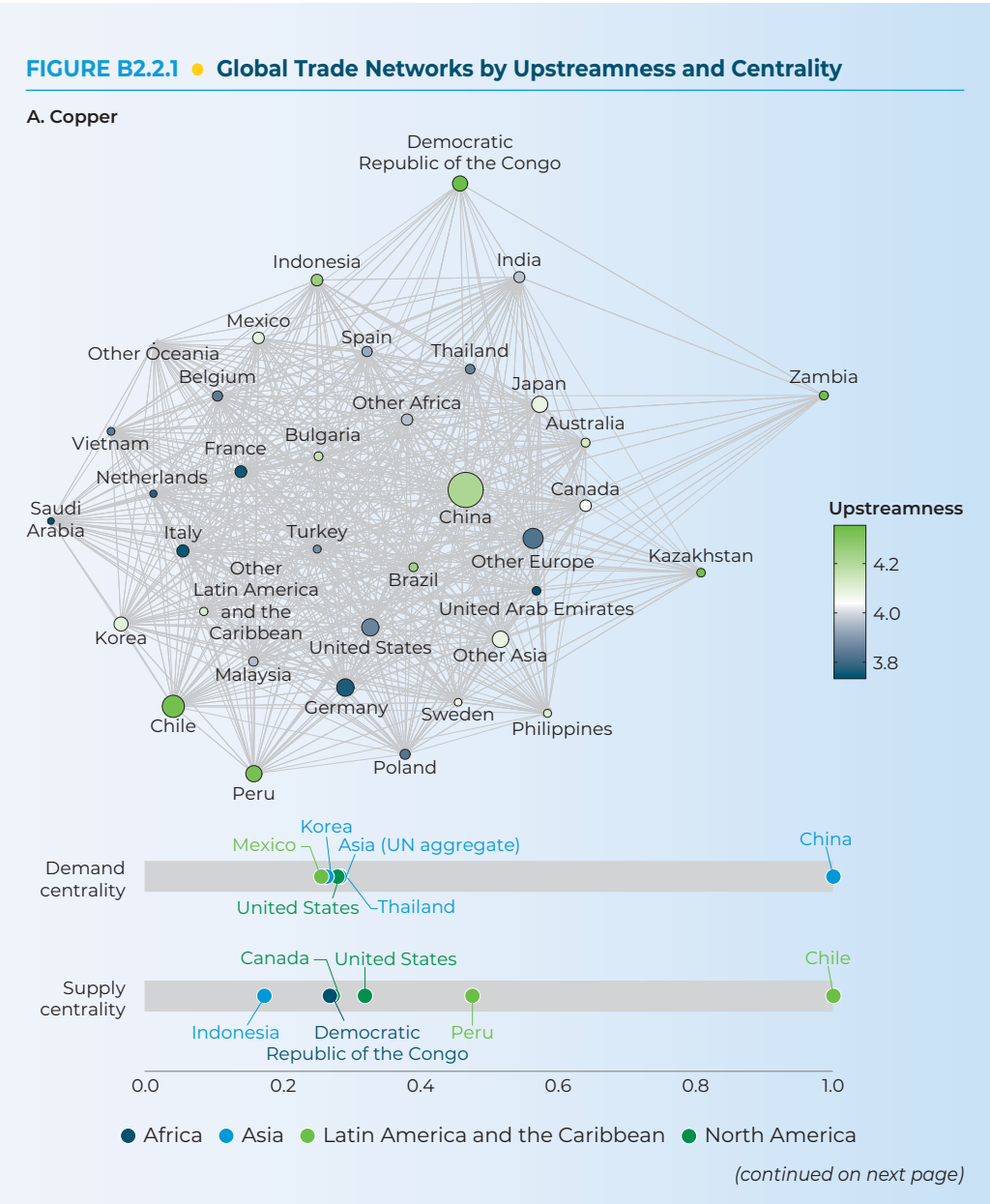
Global value chains for critical minerals are highly segmented. Countries export different types of products depending on where they sit in the chain, from raw material extraction to chemical processing to component manufacturing. In copper, for example, upstream activities include mining and primary smelting, while more downstream products involve rolling, drawing, alloying, and fabrication into valves or other components. In lithium, upstream segments cover nonmetallic mineral extraction and basic inorganic chemicals, while downstream trade includes lithium compounds, battery inputs, and storage systems.

Figure B2.2.1 shows the trade network for copper (Panel A) and lithium (Panel B). The color of the nodes reflects upstreamness; countries lower on the color scale export products used earlier in production, while those higher on the scale are positioned further downstream. Chile, the Democratic Republic of Congo, and Peru appear as upstream suppliers, while China is closer to end-use segments.

The bottom graphs in the panels display trade centrality, which captures how structurally embedded countries are in the trade network. Centrality is measured using eigenvector centrality, a recursive metric that assigns more weight to countries connected to other central nodes. It reflects not just the number of trade links, but the importance of those connections within the broader system. Supply centrality refers to a country’s systemic role as an exporter, while demand centrality captures its embeddedness as an importer across multiple trade relationships. This framework identifies important hubs on both sides: Chile and Peru emerge as core suppliers, while China, the Republic of Korea, and the United States appear as highly central importers.

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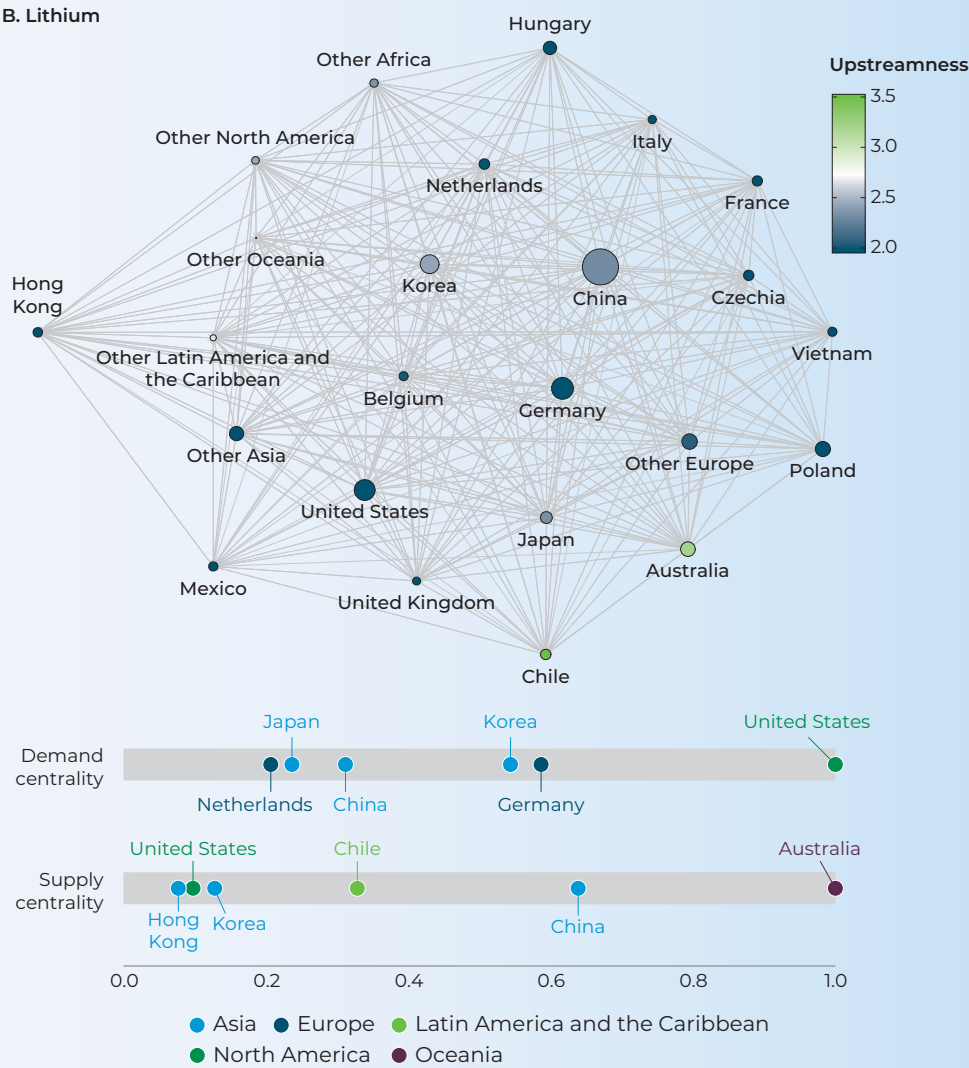
BOX 2.2 • The Global Value Chain of Critical Minerals *(continued)*



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BOX 2.2 • The Global Value Chain of Critical Minerals (continued)

FIGURE B2.2.1 • Global Trade Networks by Upstreamness and Centrality (continued)



Source: IDB staff calculations based on Comtrade Statistics.

Note: The figure maps countries' positions in copper and lithium trade networks based on upstreamness and trade centrality. Upstreamness reflects the average distance of each traded product to final demand. Trade centrality is measured using weighted eigenvector centrality, assigning higher scores to countries connected to other central nodes. Supply centrality is based on exports (outgoing flows); demand centrality on imports (incoming flows). The layout is generated using the LGL (Large Graph Layout) algorithm, which places more central and connected countries closer together. Node color indicates upstreamness; node size reflects total trade value.

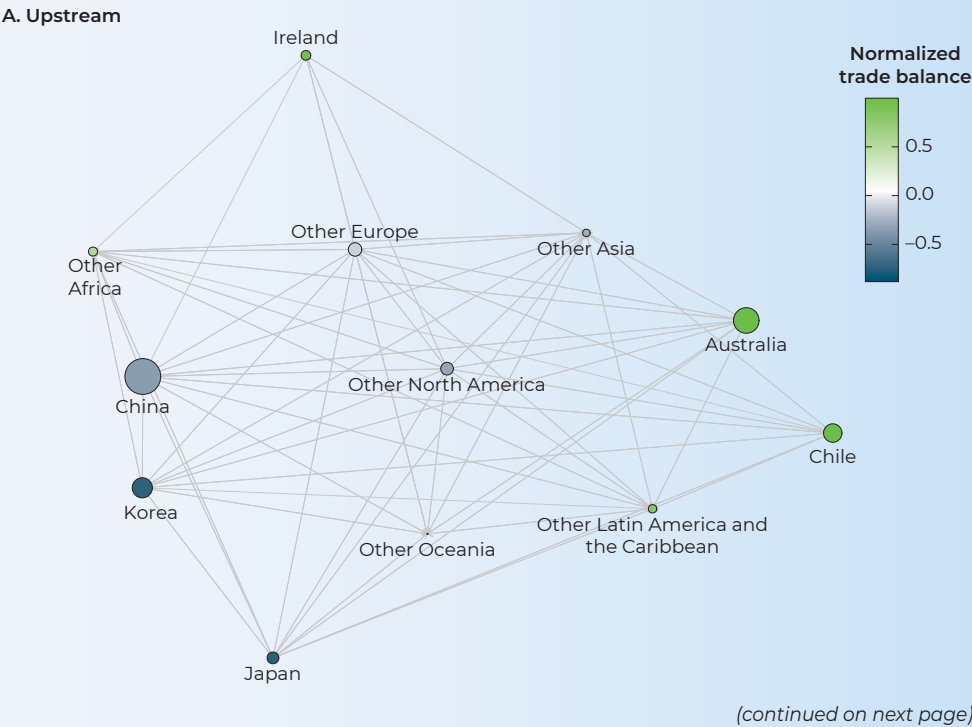
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BOX 2.2 • The Global Value Chain of Critical Minerals *(continued)*

Across both minerals, trade is concentrated at the extremes of the value chain. In copper, around 70 percent of global trade volume occurs in highly upstream segments. In lithium, nearly 80 percent is downstream. Latin American exporters are central to global supply but remain concentrated in early stages of production, with limited presence in downstream activities, where more value is typically captured.

Figure B2.2.2 presents normalized trade balances (exports minus imports) in upstream and downstream lithium products. In Panel A, showing upstream trade, Australia and Chile record large surpluses, while countries like China and Korea show deficits. Panel B shows the downstream segment, where the pattern reverses: China, Hungary, and Poland record large surpluses in battery-related products, while Germany, among other European countries, and the United States appear in deficit. These shifts in position across panels underscore functional asymmetries in the lithium value chain, between countries that export raw materials and those that dominate downstream production.

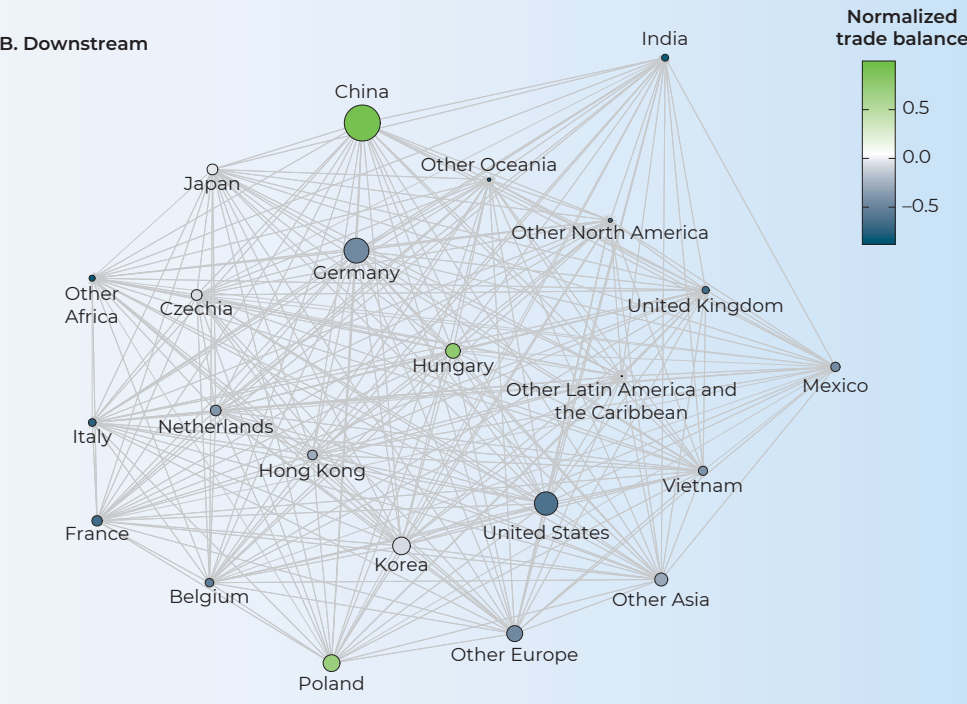
FIGURE B2.2.2 • Lithium Trade Network by Trade Balance (Exports Minus Imports)



(continued on next page)

BOX 2.2 • The Global Value Chain of Critical Minerals *(continued)*

FIGURE B2.2.2 • Lithium Trade Network by Trade Balance (Exports Minus Imports)
(continued)



Source: IDB staff calculations, based on Comtrade Statistics.

Note: The figure displays the lithium trade network based on normalized trade balances (exports minus imports), separately for products classified as upstream (Panel A) and downstream (Panel B). The classification is based on the product-level upstreamness index, with Panel A capturing the highest upstream and Panel B the lowest. Node color reflects each country's trade balance, from surplus to deficit, normalized by total trade. Network layouts are generated using the LGL (Large Graph Layout) algorithm. Node size is proportional to total trade value.

Overall, this structure reveals persistent asymmetries in how countries participate in mineral trade. While Latin America and the Caribbean is deeply embedded in upstream supply, it remains weakly connected to downstream stages, where more value is added and captured. Future gains will depend on how the region strengthens its position within trade networks and moves closer to stages of higher strategic relevance.

Given the scale, complexity, and coordination challenges inherent in mineral value chains, the most realistic strategy is to selectively target a small number of specialized, high-value activities rather than attempt broad-based industrial expansion. In copper, this includes producing high-purity and low-carbon metals, where new international requirements are already creating price premiums, as well as expanding into specialized services like geometallurgy, automation, and the integration of renewable energy into

mining and processing operations, including onsite solar and wind generation and electrification of energy-intensive stages to reduce emissions and operating costs (European Commission 2023; Igogo et al. 2020). With respect to lithium and battery materials, the most immediate prospects are in conversion, cathode precursors, and recycling, especially since many refining and direct-lithium-extraction technologies are still in early stages; this raises the risk of the region's remaining mainly an exporter of raw materials.

Finally, transparent public-private partnerships and innovation-focused financing tools can help attract technology providers and long-term buyers, particularly when regulation is stable and contracts are reliable (Ray et al. 2025).

Using Revenues Wisely: From Rents to Long-Term Assets

Even when downstream industrialization does not materialize immediately, disciplined fiscal policy can turn revenue streams into lasting public wealth. The recent history of the region shows the risks of not having such a policy. The commodity downturn of the 2010s, after the boom of the previous decade, exposed how high prices had concealed structural weaknesses in fiscal frameworks across the region. Windfalls often weakened incentives for institutional upgrading, fueled procyclical spending, and left countries exposed to sharp fiscal and macroeconomic stress when prices declined.

International experience shows this trajectory is not inevitable, and it offers one central lesson: Strong institutions—not geology—determine whether natural wealth becomes a foundation for sustained development. In Norway, for example, the country's rules-based framework and its Government Pension Fund Global helped insulate public spending from commodity cycles and preserve wealth for future generations (NBIM 2022). Botswana built institutions that support a long-term strategy of channeling diamond revenues into education and infrastructure (Acemoglu, Johnson, and Robinson 2003). Australia and Canada combined royalty systems with profit-based taxation under strong federal-provincial arrangements and directed part of their resource revenues into stabilization and heritage funds that smooth volatility and finance long-term public investment.

In these successful cases, sovereign wealth funds play a central role. When they operate within transparent, rule-based frameworks, such funds can strengthen intergenerational equity and macrofiscal resilience (Bolton, Samana, and Stiglitz 2011). They help smooth revenue volatility, prevent overheating during booms, and ensure temporary rents are converted into financial assets that benefit future generations.¹³

In Latin America and the Caribbean, established sovereign wealth funds have played an important role in managing commodity revenues, including the Economic and Social Stabilization Fund in Chile—linked primarily to copper revenues—and the Heritage and

¹³ See Al-Sadiq and Gutierrez (2023) and Luttini et al. (2026a, 2026b).

Stabilization Fund in Trinidad and Tobago for oil revenues. More recent developments in the Guiana Basin illustrate how this approach is being adopted by new producers. Since 2015, Guyana has discovered more than 11 billion barrels of recoverable oil and has moved quickly to establish the Natural Resource Fund Act (2019), which sets clear rules for deposit and withdrawal, independent oversight, and regular public reporting. Suriname, with smaller but still significant discoveries, is pursuing similar reforms under tighter fiscal constraints.

In sum, countries that establish fiscal anchors, savings mechanisms, and transparent public investment systems before revenues peak are far better positioned to manage volatility and avoid macroeconomic overheating. More broadly, well-designed fiscal regimes must balance efficiency (capturing revenue streams without discouraging investment), equity (ensuring broad public benefit), and stability (ensuring fiscal frameworks are designed for, and consistently followed across, economic cycles).

In Latin America and the Caribbean, fiscal architectures remain fragmented overall. Many countries rely heavily on ad valorem royalties—easy to collect but distortionary and procyclical—while profit- and rent-based taxes, which better align incentives, are less common and harder to administer. Informality and illegal mining further weaken fiscal capacity and erode public trust (Davis and Smith 2020).

The overarching message is simple: Institutions must come first. Countries that legislate early, strengthen oversight, and anchor fiscal rules in long-term development goals are best positioned to turn temporary rents into lasting assets—financing the energy transition, productivity-enhancing investment, and resilient public wealth.

Toward a New Fiscal–Industrial Consensus

In a world where investors prize predictability, transparency, and sustainability, fiscal discipline and institutional upgrading have become forms of strategic capital. The path forward combines a cleaner, more productive extractive base with selective upstream and downstream upgrading, underpinned by a fiscal architecture that is efficient, countercyclical, transparent, and oriented toward productivity-enhancing investment. With the right approach, Latin America and the Caribbean can turn today's mineral opportunity into higher productivity, deeper regional value chains, and lasting public wealth, moving the region decisively from extraction toward transformation and long-term prosperity.

CHAPTER 3

External Shocks, Policy Buffers, and Resilience

Global risk tolerance is inherently fragile and prone to sudden shifts. Recent geopolitical and trade-related developments have tested this fragility, contributing to heightened uncertainty in 2025. To date, markets have remained broadly resilient, despite substantial underlying risks. Emerging market economies (EMEs) are particularly vulnerable to changes in global risk sentiment. Such episodes of heightened risk aversion are typically marked by synchronized asset price declines, retrenchment of capital flows, tighter external financing conditions, and sharp commodity price adjustments.

For Latin America and the Caribbean, these dynamics are particularly consequential. The region's exposure to global periods of heightened risk aversion (known as risk-off episodes) is amplified by three structural features: a high reliance on commodity exports—whose prices typically decline during risk-off periods; a strong dependence on private capital flows that are procyclical with the global financial cycle; and, in several economies, limited fiscal space or less credible policy frameworks, which constrain the ability to absorb shocks. When global risk tolerance deteriorates, these vulnerabilities interact to transmit weaker commodity prices, wider sovereign spreads, and exchange rate depreciations rapidly to domestic demand, amplifying downturns and limiting the scope for countercyclical policy responses.

Over the course of 2025, global financial conditions were shaped by a broad depreciation of the U.S. dollar, reflecting shifts in portfolio allocations, increased currency-hedging activity, and concerns over U.S. fiscal sustainability. Historically, such episodes have provided a comparatively supportive external environment for EMEs, often associated with firmer commodity prices and improved access to external financing. This apparent calm should not necessarily be interpreted as durable, however; leverage has increased, asset valuations remain stretched, and policy uncertainty persists.¹ As a result, the currently benign external environment could unwind rapidly if global risk sentiment deteriorates.

¹ See, for example, the International Monetary Fund's Global Financial Stability Report (IMF 2025a), the Federal Reserve's Financial Stability Report (Federal Reserve Board 2025), the Bank of England's Financial Stability Report (Bank of England 2025), the Financial Stability Board's Annual Report (Financial Stability Board 2024), and the European Central Bank's Financial Stability Review (European Central Bank 2025), all of which point to elevated or stretched asset valuations, rising leverage, and heightened policy or geopolitical uncertainty as key vulnerabilities.

This chapter examines how shifts in global risk appetite propagate to economies in Latin America and the Caribbean and assesses the role of policy frameworks in shaping resilience to external shocks. It quantifies the real and financial spillovers from a global risk-off episode, highlights key transmission channels—particularly commodity prices, exchange rates, and financing conditions—and evaluates how fiscal space, exchange rate regimes, and macrofinancial credibility influence adjustment dynamics across countries.

The analysis shows that a sudden shift in risk tolerance at the global level generates sizable and asymmetric effects across the region, with particularly pronounced impacts in commodity-exporting economies. Declines in output, terms-of-trade losses, and tighter financial conditions account for much of the transmission. Countries with stronger policy frameworks, greater fiscal space, and credible macroeconomic institutions are better able to absorb these shocks, while weaker fundamentals amplify their effects. These findings shed light on the importance of rebuilding policy buffers and strengthening macrofinancial credibility to enhance resilience to future external shocks—an imperative that frames the analysis in the chapters that follow.

Why the Global Financial Cycle Matters for Latin America and the Caribbean

A large body of research documents a systematic link between fluctuations in the U.S. dollar and the global financial cycle. Historically, episodes of dollar strength have coincided with a higher global risk premium, tighter credit conditions, and a retrenchment of cross-border capital flows (Miranda-Agrippino and Rey 2022; Rey 2013). Importantly, these relationships have proved remarkably robust across episodes and persist even after accounting for U.S. monetary policy or domestic financial conditions (Obstfeld and Zhou 2022). As a result, the dollar has tended to serve as a reliable barometer of global risk sentiment; when it appreciates, global liquidity contracts, financial conditions tighten, and economic activity in emerging market economies slows, particularly through trade and financial channels.

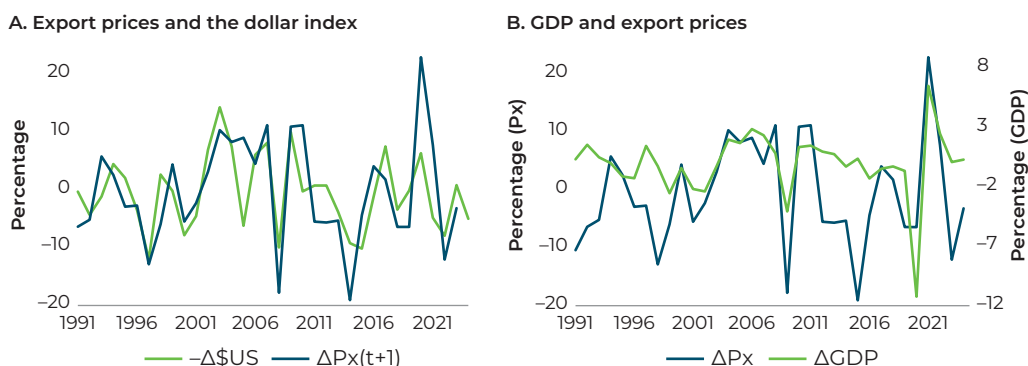
Sudden changes in the dollar are often associated with a reassessment of risk. In fact, the U.S. dollar has exhibited pronounced, decade-long swings over the past thirty years, with three major appreciation episodes having occurred since the early 1990s (Figure 3.1). To assess spillovers to emerging markets, this chapter focuses on a trade-weighted dollar index against major advanced-economy currencies—a measure that is plausibly more exogenous to conditions in EMEs.

FIGURE 3.1 • The Dollar Cycle

Source: IDB staff calculations. The effective exchange rate is sourced from the Bank for International Settlements.
 Note: The dollar index used is the narrow nominal effective exchange rate, normalized such that January 1990 = 100. The figure defines the exchange rate in terms of foreign currency per U.S. dollar, so that an increase represents an appreciation of the U.S. dollar. The lines in the graph indicate significant uncertainty-related world events identified by Piffer and Podstawski (2018). The time axis labels are from January of each year.

Risk-off episodes typically trigger a flight to safety toward dollar assets, leading to dollar appreciation and a tightening of global financial conditions. The dollar's dual role as both a safe asset and the dominant funding and invoicing currency amplifies these dynamics, making its fluctuations a central channel through which global financial shocks are transmitted to emerging markets. Historically, strong-dollar episodes have coincided with weaker capital flows to EMEs, softer global demand, and lower commodity prices.

Commodity prices, in particular, move closely with the global dollar cycle (Figure 3.2, Panel A), reflecting the combined effects of tighter financial conditions and weaker international trade and industrial activity. For commodity-exporting EMEs, these price swings are a key driver of business cycle fluctuations, as documented by Juvenal and Petrella (2024; Figure 3.2, Panel B). In Latin America and the Caribbean, where commodities account for a large share of exports and fiscal revenues, dollar-driven

FIGURE 3.2 • Motivating Evidence

Source: IDB staff calculations, based on data from IMF International Financial Statistics, BIS, and Juvenal and Petrella (2024).

Note: Panel A plots the negative of the one-year growth rate of the narrow U.S. dollar index, so that an increase corresponds to a weakening of the U.S. dollar against U.S. trade partners, and a decrease corresponds to a strengthening. This series is shown alongside the forward one-year growth rate of export prices for the countries listed below. Panel B plots the one-year growth rate of real GDP against the contemporaneous one-year growth rate of export prices. The sample includes Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Jamaica, Mexico, Panama, Peru, Trinidad and Tobago, Uruguay, and Venezuela.

commodity volatility remains a central source of macroeconomic vulnerability, shaping growth dynamics, external balances, and fiscal outcomes.²

Spillovers from a Shift in Global Risk

This section examines how shifts in global risk appetite are transmitted to EMEs, identifying risk-off shocks as U.S. dollar appreciations driven by changes in global risk sentiment. These shocks propagate rapidly through trade, financial, and commodity-price channels, generating sizable and persistent macroeconomic effects across emerging economies (Figure 3.3).³

In Latin America and the Caribbean, the effects are strongly contractionary.⁴ As global financing conditions tighten, investor confidence weakens and domestic demand slows. Inflation declines amid subdued activity, even as local currencies depreciate.

² As shown by Di Pace, Juvenal, and Petrella (2025), export prices are a key channel through which commodity price fluctuations transmit to the domestic economy, justified by the significant portion of primary commodities in total exports. Throughout this analysis, export prices are used to gauge the transmission of commodity price fluctuations in EMEs.

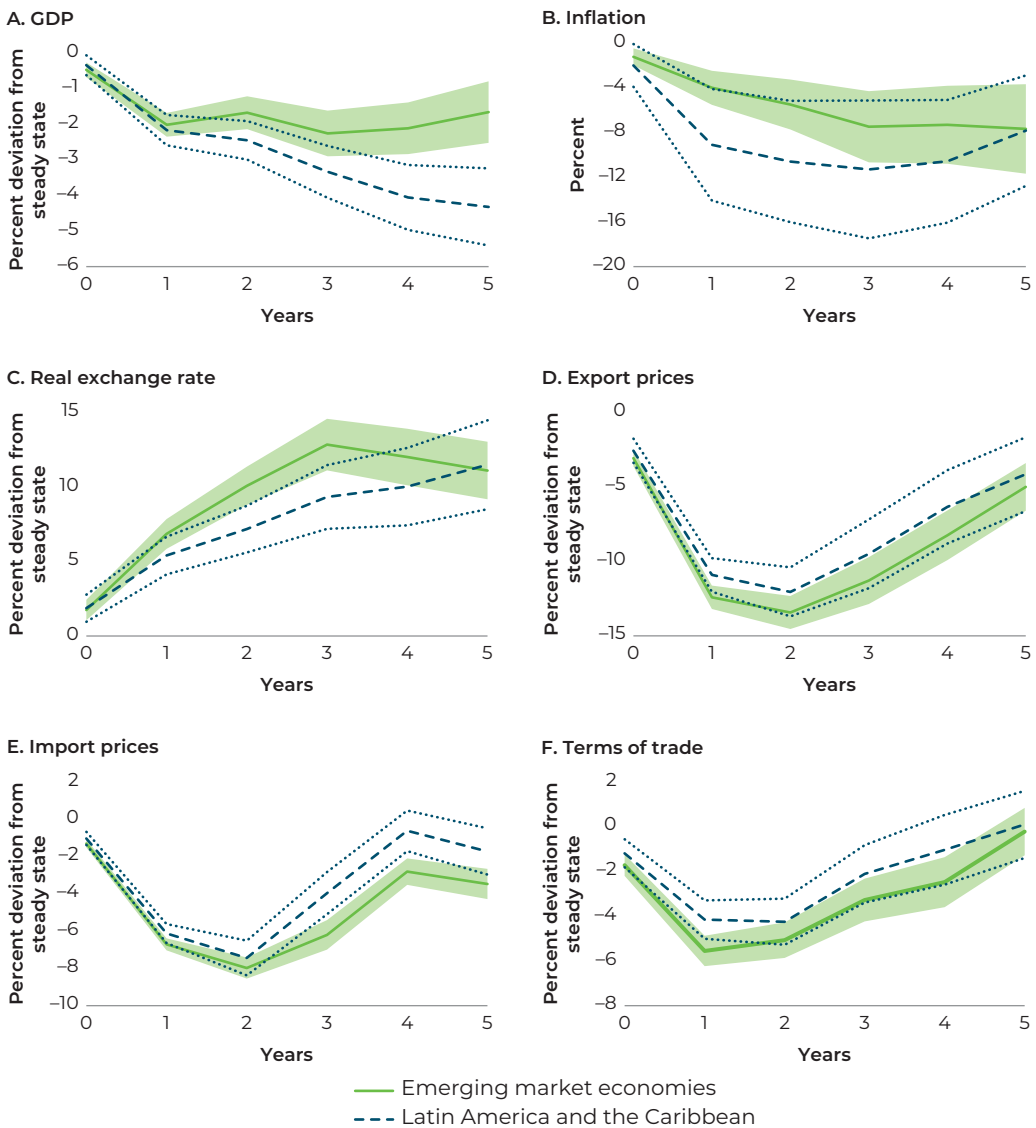
³ The identification strategy follows Juvenal and Petrella (2024). The analysis is grounded in the standard risk-off and flight-to-safety framework, under which emerging market growth slows and Latin America and the Caribbean are affected through trade and financial channels. While this mechanism is well established, recent episodes suggest that global risk dynamics may at times depart from this canonical pattern, reflecting heightened volatility and evolving market features such as elevated yields in advanced economies, rising gold prices, and a weaker U.S. dollar. These conditions may modify transmission channels, including perceptions of relative risk across emerging and advanced economies.

⁴ The results for Latin America and the Caribbean closely mirror those of the broader EME group. Hence, in the exercises below that exploit the cross-sectional dimension of the panel, the larger dataset is used.

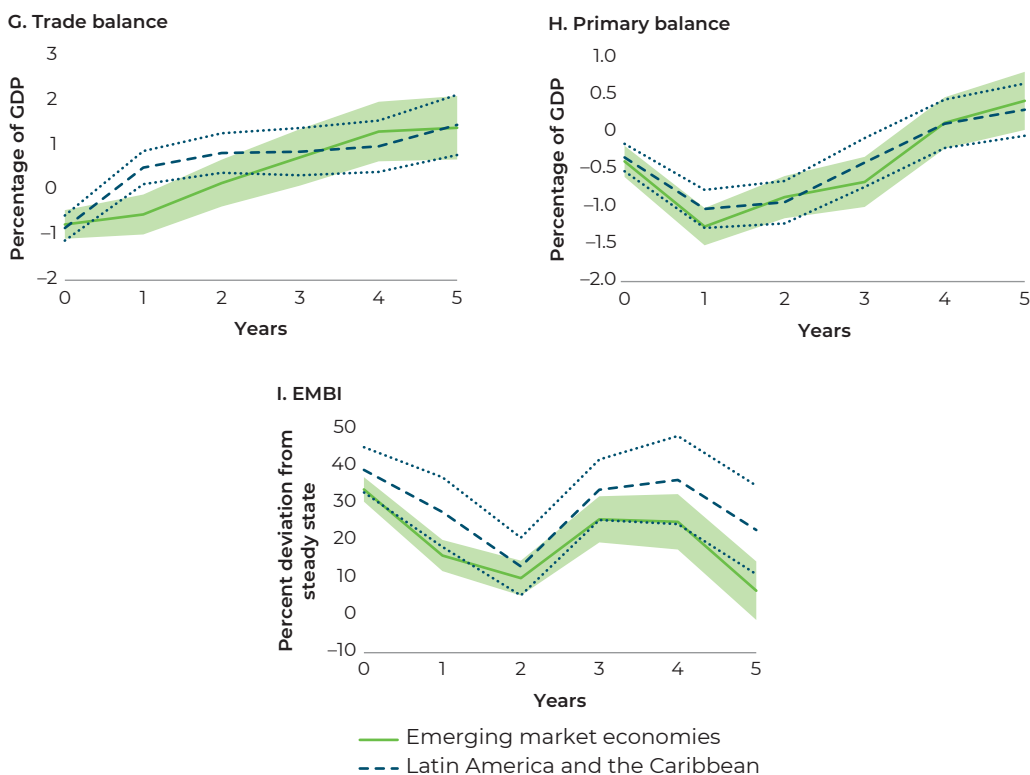
The real exchange rate depreciation is the mirror image of the dollar's strengthening, reflecting the global reallocation of liquidity toward dollar assets.

Financial conditions tighten sharply as sovereign spreads widen and credit costs rise, further restraining private investment and consumption. Limited fiscal buffers and constrained market access often prevent a countercyclical policy response, increasing the risk that the initial shock will translate into a prolonged slowdown.

FIGURE 3.3 • Spillovers of a Shift in Risk Appetite



(continued on next page)

FIGURE 3.3 • Spillovers of a Shift in Risk Appetite *(continued)*

Source: IDB staff calculations, based on Juvenal and Petrella (2024).

Note: The impulse responses show the average effect of a one-standard-deviation dollar appreciation driven by a shift in risk appetite. Solid lines denote emerging market economies, while the dashed lines refer to Latin American and Caribbean countries. Shaded areas and the areas between dotted lines denote 68 percent confidence intervals. The analysis uses data covering the period 1990–2019.

A key transmission channel operates through export and commodity prices, which fall as global trade and economic activity contract. For commodity-exporting EMEs, the resulting deterioration in the terms of trade erodes export revenues and external income, amplifying the impact of the global shock. The trade balance and fiscal position adjust only gradually, constrained by import compression and limited space for countercyclical fiscal responses.

Overall, the evidence supports the view that flight-to-safety shocks remain a powerful source of vulnerability for EMEs. By combining tighter financial conditions with weaker external demand and lower export prices, these episodes reinforce the region's macrofinancial sensitivity to swings in global risk appetite.

The strength and persistence of these spillovers reflect the channels through which global financial shocks are transmitted and amplified across EMEs. In particular,

fluctuations in commodity prices and exchange rates play a central role in shaping how global risk shocks propagate through domestic economies, affecting external balances, fiscal revenues, and financial conditions. The next section examines these transmission mechanisms in detail.

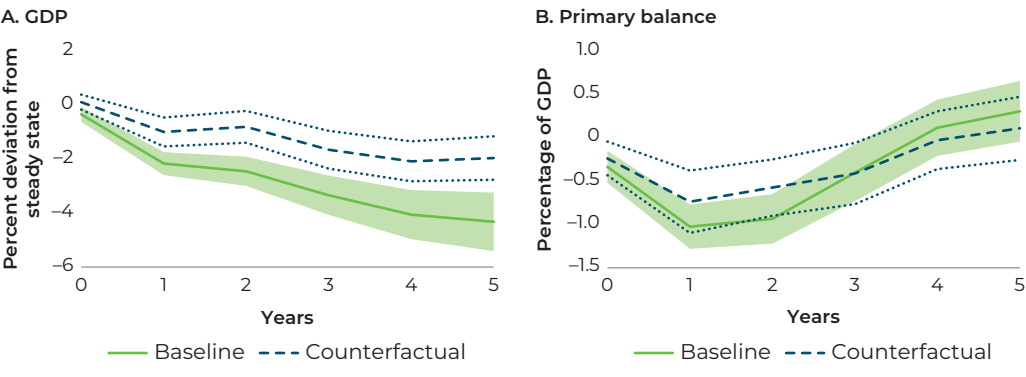
The Role of Commodity Prices and the Exchange Rate

In EMEs, global financial shocks are amplified primarily through movements in commodity prices and real exchange rates, with additional effects transmitted through income, fiscal, and balance-sheet channels. In a typical flight-to-safety episode, global investors rebalance toward dollar assets, tightening global financial conditions and weakening external demand. As a result, commodity prices fall sharply, while local currencies come under pressure. For commodity exporters, this combination directly reduces export proceeds, worsens the terms of trade, and weakens both external and fiscal balances. The ensuing loss of income amplifies the downturn through real and financial channels by compressing investment and consumption, eroding collateral values, and worsening debt dynamics. These effects are particularly severe in countries with limited export diversification and high external liabilities.

A key amplification mechanism operates through fiscal channels. The fiscal responses further compound vulnerabilities, as falling commodity revenues and shrinking tax bases constrain governments' ability to sustain spending precisely when countercyclical support is most needed (see Petrella [Ⓢ](#) Juvenal [Ⓢ](#) and Di Pace [Ⓢ](#) 2025). While currency depreciation may mechanically boost nominal fiscal receipts, this effect is often outweighed by lower domestic demand and rising debt-service costs. In economies with limited credibility or market access, policy responses can turn procyclical, as authorities tighten fiscal policy to preserve stability and thereby deepen the downturn. This mechanism helps explain why global financial shocks often translate into prolonged recessions, particularly in Latin America and the Caribbean, where dependence on commodity revenues and limited fiscal buffers remain structural features.

The counterfactual example in Figure 3.4 underscores the centrality of these channels. When the decline in commodity prices and the real exchange rate adjustment are “shut down,” the resulting contractions in GDP and fiscal balances are far more moderate. This exercise reveals that the bulk of the adjustment observed during global risk-off episodes operates through movements in export prices and exchange rates.

FIGURE 3.4 • Shutting Down the Commodity Price and the Exchange Rate Channels



Source: IDB staff calculations, based on Juvenal and Petrella (2024).
Note: The impulse responses show the average effect of a one-standard-deviation increase in the dollar index, driven by a shift in risk appetite. The solid lines are the baseline responses shown in Figure 3.3, while the dashed lines denote a counterfactual response, assuming no movements in the price of exports and the real exchange rate. Shaded areas and the areas between dotted lines denote 68 percent confidence intervals. The analysis uses data covering the period 1990–2019.

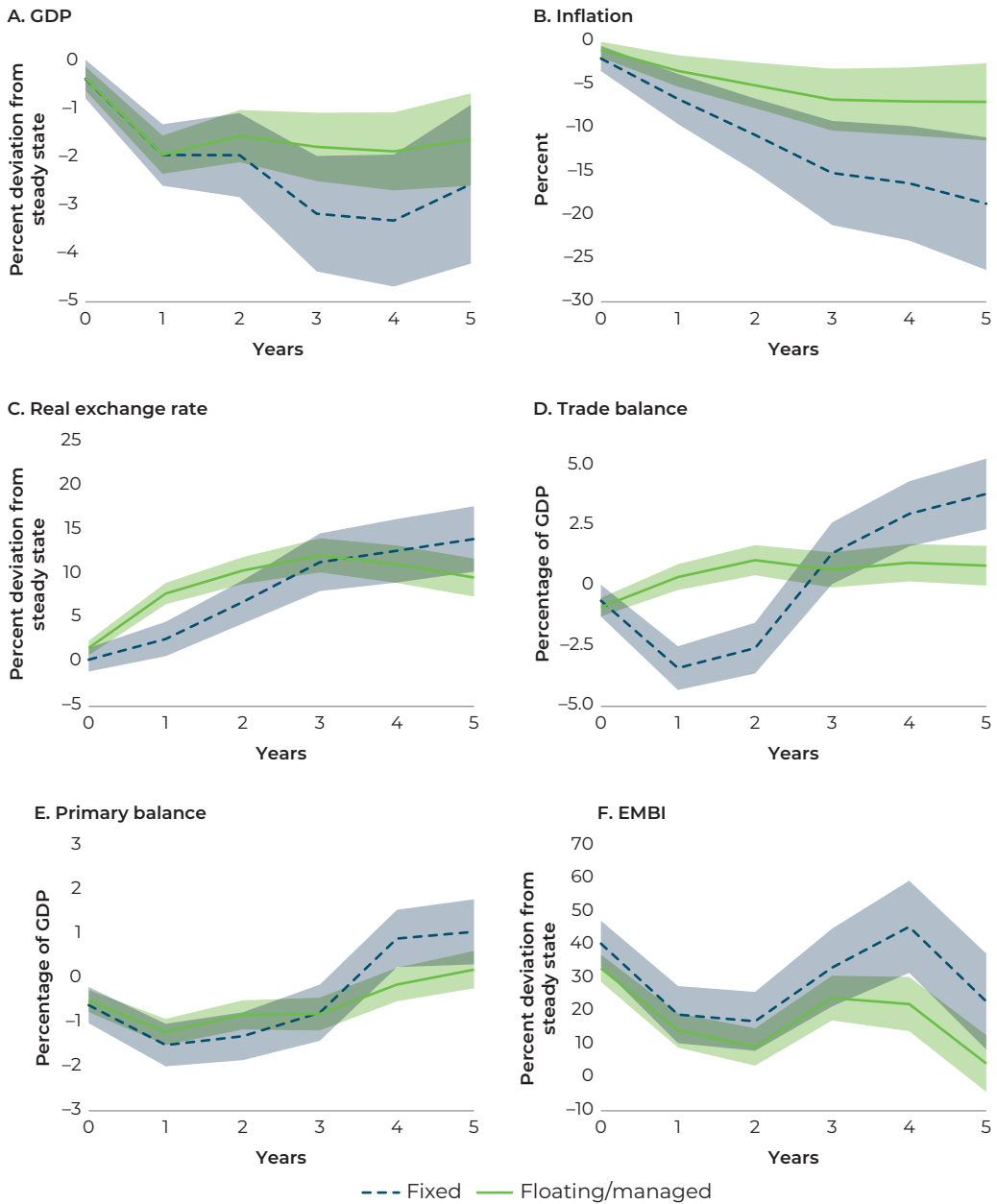
Taken together, these findings highlight the critical role of export price and exchange rate dynamics in shaping how global financial shocks are transmitted and magnified across EMEs. For Latin America and the Caribbean, where commodity exports, fiscal revenues, and financial conditions are closely intertwined, these channels are central to understanding the persistent vulnerability to swings in global risk appetite and dollar strength. The next section explores how countries’ exchange rate regimes influence the pace and nature of this adjustment.

Exchange Rate Regimes and Macroeconomic Adjustment

The exchange rate regime is pivotal to shaping how EMEs adjust to shifts in global risk appetite. Figure 3.5 contrasts the macroeconomic responses to such shifts under fixed and flexible exchange rate arrangements, demonstrating the different adjustment paths that arise when the dollar strengthens sharply.

Under fixed exchange rate regimes, the adjustment to global risk shocks is larger and protracted. With limited capacity for nominal rate movement, countries must absorb the shock through real adjustment, mainly by way of declines in output and employment. As a result, contractions in GDP tend to be deeper and recoveries slower. Inflationary pressures remain subdued or even turn deflationary, as weak domestic demand dominates any imported price effects.

By contrast, flexible regimes can rely on currency depreciation as a buffer. The nominal depreciation facilitates real exchange rate adjustment, helping restore competitiveness and partially cushioning the fall in output. While depreciation may temporarily raise

FIGURE 3.5 • Fixed versus Floating Exchange Rate Regimes

Source: IDB staff calculations, based on Juvenal and Petrella (2024). Exchange rate regimes are from Ilzetzki, Reinhart, and Rogoff (2019).

Note: The impulse responses show the average effect of a one-standard-deviation increase in the dollar index, driven by a shift in risk appetite. Solid lines denote countries with floating exchange rates, while dashed lines refer to countries under a fixed exchange rate regime. Shaded areas denote 68 percent confidence intervals. The analysis uses data covering the period 1990–2019.

import prices and inflation, these effects are generally offset by soft demand and anchored inflation expectations (see Chapter 5 for more details about exchange rate regimes). The overall result is a shallower contraction and a quicker stabilization in activity.

The trade balance also adjusts more efficiently under flexible regimes. The depreciation improves export competitiveness and compresses imports, allowing for earlier external rebalancing. Fixed regimes, in contrast, often face an initial deterioration in the trade balance, as the decline in export prices and terms of trade hits revenues while real adjustment lags.

Fiscal outcomes diverge, as well. In fixed regimes, the erosion of revenues from commodity exports and the absence of monetary flexibility tighten financing constraints. Governments often respond by cutting spending to preserve stability, resulting in procyclical fiscal tightening. Flexible regimes, where depreciation supports local-currency revenues and debt service, generally see a more gradual adjustment in the primary balance.

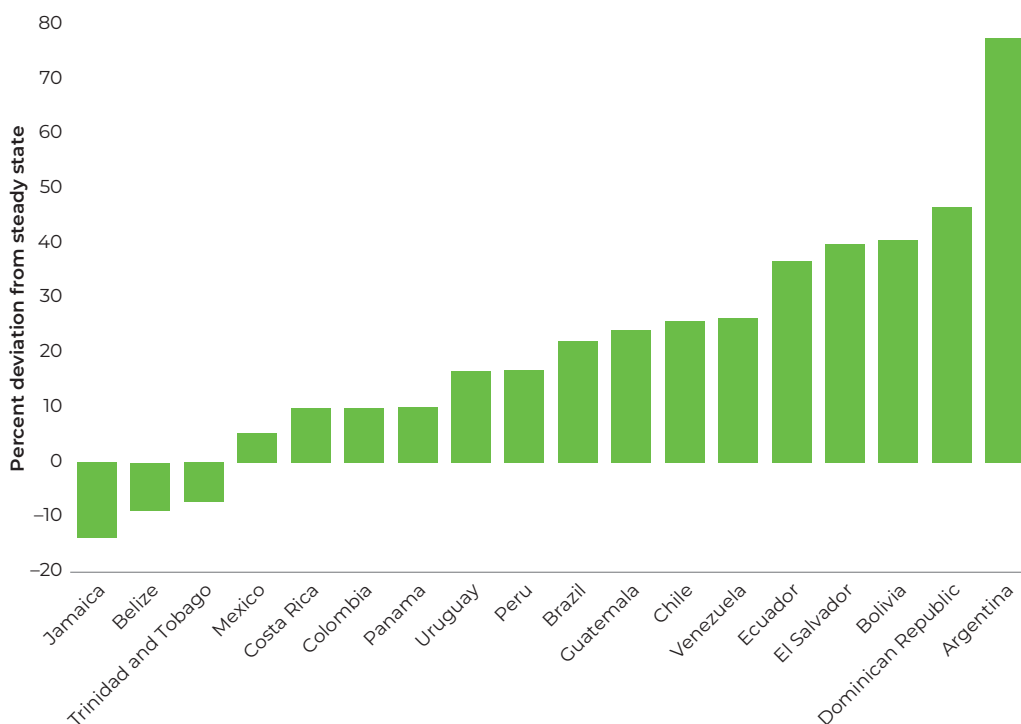
Financial markets respond adversely across both regimes, with sovereign spreads widening as global risk aversion rises. In fixed regimes, however, the rigidity of the exchange rate can heighten investor concerns about reserve adequacy and external imbalances, leading to more persistent increases in spreads. Flexible regimes, by contrast, tend to retain greater market confidence, thanks to their built-in shock-absorbing capacity.

Overall, the evidence shows that exchange rate flexibility, where feasible, helps mitigate the macroeconomic costs of global risk shocks. Flexible regimes allow for smoother external adjustment and support faster recovery. For countries operating under fixed or heavily managed regimes, the maintenance of adequate reserves, strong fiscal anchors, and robust macroprudential frameworks can be similarly stabilizing, limiting the transmission of external pressures to output and public finances. Rebuilding policy buffers and strengthening macrofinancial credibility is essential to enhancing resilience to future external shocks. These themes are further developed in the chapters that follow.

Macrofinancial Credibility as a Shield against Global Financial Shocks

Establishing macrofinancial credibility is essential for enhancing resilience to fluctuations in the global financial cycle. Countries that enter periods of global stress with sound fiscal positions, credible monetary policy frameworks, and well-anchored expectations are better equipped to absorb external shocks. Credibility helps preserve investor confidence, limiting risk repricing and stabilizing access to financing even when global conditions tighten.

A useful way to gauge such resilience is by examining the sensitivity of sovereign risk premia to global financial shocks, proxied by movements in Emerging Markets Bond Index (EMBI) spreads. As illustrated in Figure 3.6, Latin American and Caribbean economies display significant heterogeneity in this dimension. Countries with stronger macrofinancial frameworks—such as Chile, Jamaica, Mexico, Panama,

FIGURE 3.6 • EMBI Spread Response

Source: IDB staff calculations.

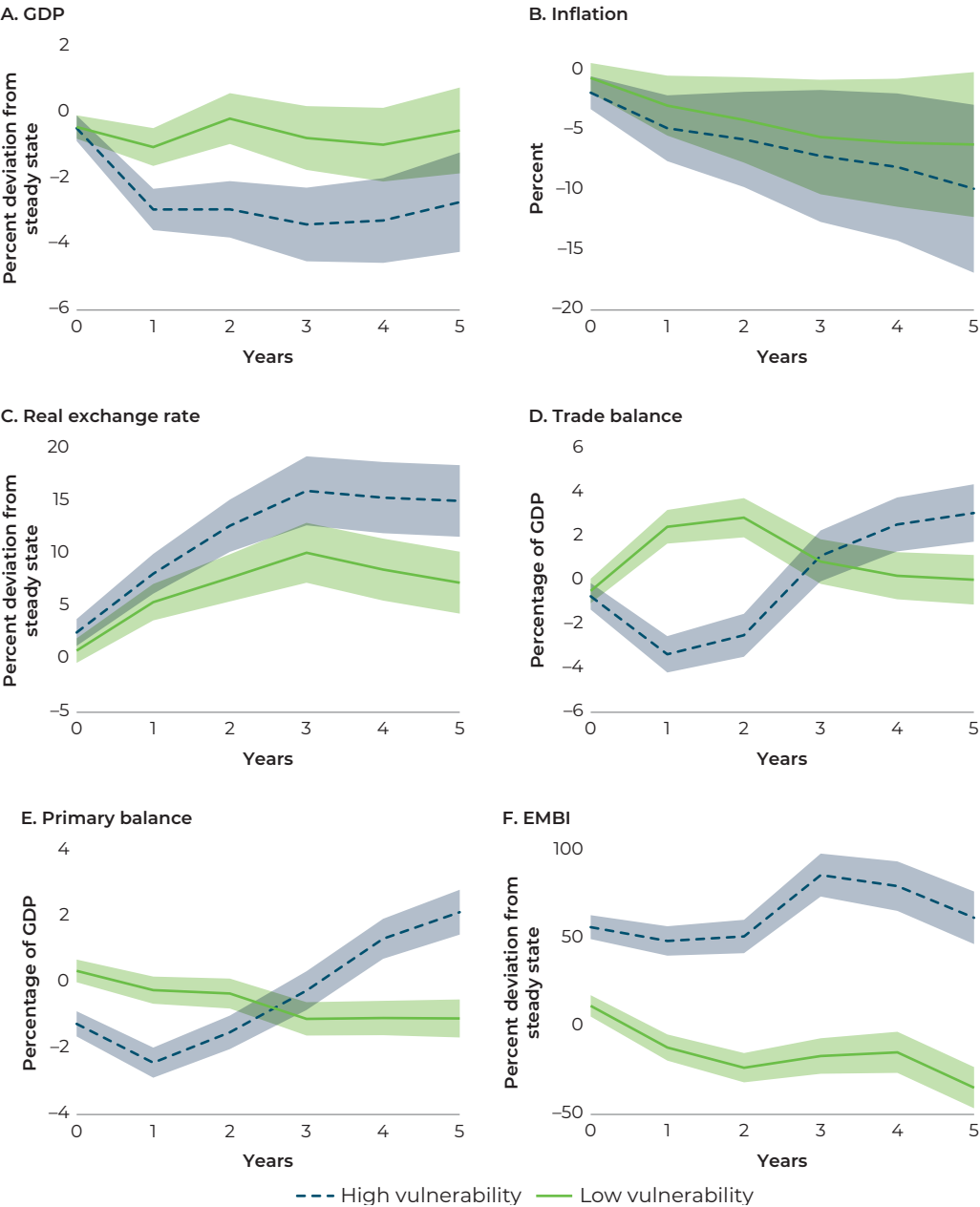
Note: The figure reports country-specific responses of EMBI spreads to a global risk shock, measured as the average change over a five-year horizon. The analysis uses data covering the period 1990–2019.

and Uruguay—exhibit relatively contained EMBI responses, suggesting that markets view them as more resilient. In contrast, countries with weaker fundamentals—such as Argentina, Bolivia, Ecuador, El Salvador, and Venezuela—show pronounced and persistent spread increases, reflecting limited policy credibility, high financing needs, and constrained market access.⁵

The empirical evidence in Figure 3.7 confirms that credibility substantially shapes macroeconomic outcomes following global risk shocks. Countries with more resilient EMBI profiles experience shallower recessions, milder real exchange rate adjustments, and more stable fiscal balances. Investor confidence and anchored expectations allow these economies to maintain market access and deploy countercyclical policy tools, helping them to moderate the downturn and support recovery.

⁵ Recent improvements in macroeconomic fundamentals—particularly in Argentina—are notable. However, the analysis is based on historical data spanning periods characterized by high volatility and elevated country risk. The grouping of Argentina, Bolivia, Ecuador, El Salvador, and Venezuela reflects these historical conditions and masks considerable heterogeneity across countries and over time; the results should, therefore, not be interpreted as an assessment of current fundamentals.

FIGURE 3.7 • Domestic Financial Vulnerability and Shock Resilience



Source: IDB staff calculations, based on Juvenal and Petrella (2024).
Note: The impulse responses show the average effect of a one-standard-deviation increase in the dollar index, driven by a shift in risk appetite. Solid lines denote countries with lower EMBI spreads (low vulnerability), while dashed lines refer to countries with higher EMBI spreads (high vulnerability). Shaded areas denote 68 percent confidence intervals. The analysis uses data covering the period 1990–2019.

By contrast, vulnerable economies face a much harsher adjustment. A sudden loss of confidence and widening EMBI spreads rapidly transmit global shocks through tighter domestic financial conditions, capital outflows, and sharp exchange rate depreciation. With limited fiscal space and rising borrowing costs, these countries are often forced into procyclical fiscal tightening at the trough of the cycle, deepening the contraction and delaying recovery. In such contexts, the EMBI spread acts not merely as a reflection of sovereign risk but as a mechanism of amplification, translating shifts in global risk appetite into domestic financial stress.

Inflation dynamics also differ markedly across groups. In low-vulnerability economies, anchored expectations and stable policy frameworks prevent depreciation from feeding into inflation, keeping price dynamics contained. In high-vulnerability economies, disinflation tends to dominate, driven by collapsing domestic demand rather than policy credibility, and underscoring the economic cost of adjustment through contraction rather than stabilization.

Overall, the results show that macrofinancial credibility is a crucial line of defense against global financial shocks. Strengthening fiscal anchors, enhancing monetary policy credibility, and deepening domestic financial markets can significantly reduce the sensitivity of sovereign spreads to global risk. For countries in Latin America and the Caribbean, investing in credible and transparent policy frameworks is, therefore, not only a matter of long-term stability but a strategic shield against the global financial cycle.

Looking Ahead: Building Resilience

In an environment of heightened global uncertainty and recurrent commodity price volatility, EMEs remain vulnerable to abrupt shifts in investor sentiment, terms-of-trade shocks, and external financing pressures. The evidence presented in this chapter shows that macroeconomic credibility and financial resilience fundamentally shape how economies absorb and adjust to episodes of global financial stress.

Countries with strong policy frameworks experience more contained output losses, moderate exchange rate adjustments, and greater room for countercyclical policy. By contrast, economies with weak frameworks or rigid exchange rate arrangements face amplified effects, which are manifested in tighter financing conditions, abrupt fiscal consolidation, and prolonged recessions.

Importantly, the EMBI spread serves not only as a proxy for underlying sovereign risk but as a transmission channel through which global shocks are propagated. Building resilience to such shocks requires a comprehensive approach that combines macroeconomic discipline, institutional credibility, and structural transformation. The following policy priorities emerge.

Rebuild and preserve fiscal space. With the post-pandemic recovery largely complete and growth in Latin America and the Caribbean holding up in 2025 despite global headwinds, the current juncture provides an opportunity to rebuild and preserve fiscal space. Adequate fiscal buffers ensure that automatic stabilizers can operate during downturns. In countries with limited credibility, reinforcing fiscal anchors through transparent medium-term fiscal frameworks is essential to preserve investor confidence and maintain access to market financing.

Enhance exchange rate flexibility where appropriate. Flexible regimes allow for quicker relative price adjustments, facilitate external rebalancing, and reduce the burden of adjustment on output and employment when global financial conditions tighten.

Improve fiscal policy design and targeting. In fiscally constrained settings, well-targeted spending—especially through social transfers and subsidies—can enhance the effectiveness of support measures while limiting fiscal drift and reducing the need for abrupt consolidation when shocks hit.

Strengthen external buffers and reserve adequacy. Robust reserves bolster confidence during episodes of global financial tightening, particularly for countries with fixed or heavily managed exchange rate regimes and limited access to diversified sources of external financing.

Improve external resilience through the use of effective risk management tools. Recent innovations in regional financial instruments, which complement external buffers, have strengthened the ability of countries in the region to manage these global risks. In partnership with the Inter-American Development Bank, several have expanded the use of local-currency conversions, interest-rate fixings, and commodity hedges—mechanisms that help insulate public finances from exchange rate volatility, spikes in dollar funding costs, commodity-price shocks, and natural disasters.

Deepen domestic financial markets, and broaden the investor base. The expansion of local-currency debt markets and the increase in the length of maturities reduce reliance on volatile external flows and dampen the amplification of global financial shocks through sovereign spreads.

CHAPTER 4

Fiscal Policy in Uncertain Times: Old Lessons, New Tools

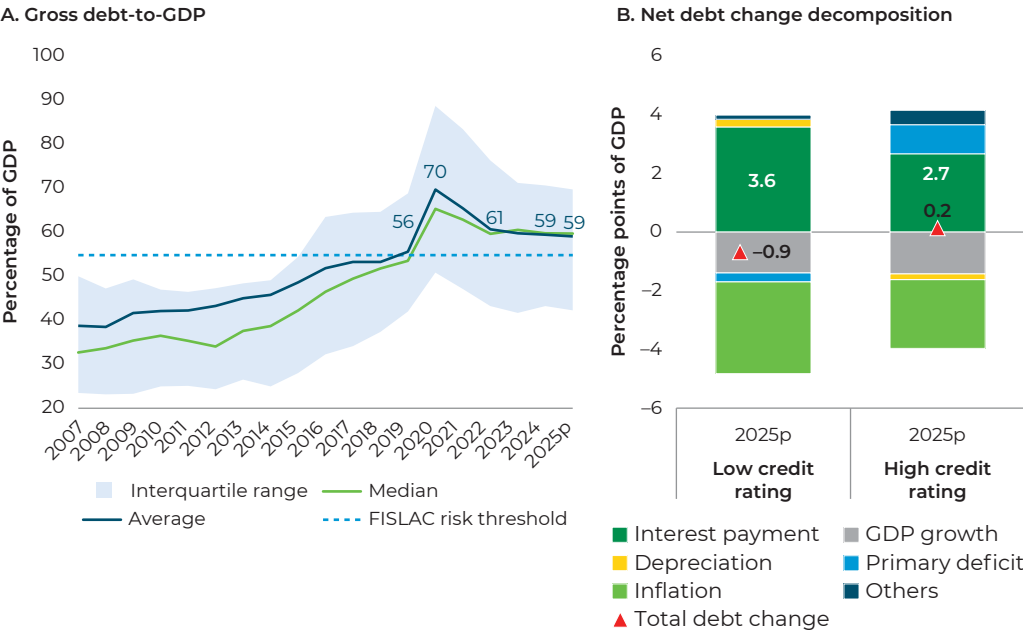
Fiscal consolidation is underway in Latin America and the Caribbean, but it is incomplete. Fiscal space remains limited; the region is more exposed to global risk shocks; and debt dynamics are more sensitive to higher interest rates. As the economic rebound and the inflation surge unwind, public debt remains elevated, while debt service costs continue to rise. At the same time, heightened global uncertainty is tightening external financing conditions and reshaping yield curves, complicating consolidation efforts. Resilience is also being weakened by policy responses in several countries, including cuts or freezes to public investment, procyclical increases in current spending during revenue upswings, and shorter debt maturities that elevate rollover risk. Rebuilding fiscal space, therefore, requires both sustained adjustment and stronger institutional frameworks that anchor credibility.

A more uncertain environment also requires better tools to manage fiscal risks. Strengthening fiscal rules and their implementation is essential for improving policy predictability and market perceptions. Active debt-maturity management can help mitigate refinancing risks amid volatile global conditions, while digital tools in tax administration, when embedded in capable institutions, can support revenue performance. This chapter examines how these elements interact with current debt dynamics, the risks posed by tighter global conditions, and some policy options available to reinforce fiscal sustainability.

Fiscal Outlook: Consolidation Has Stalled, Debt Service Is Rising

Global financial conditions remain tight, and public debt levels in Latin America and the Caribbean still reflect the pandemic legacy and the subsequent monetary tightening cycle. After peaking in 2020, debt-to-GDP ratios declined as activity recovered and emergency measures were withdrawn, supported by nominal growth and initial consolidation. Over the past year, however, progress has stalled, with debt stabilizing above both pre-2020 levels and estimated risk thresholds (Figure 4.1, Panel A).

FIGURE 4.1 • Debt in Latin America and the Caribbean



Source: IDB staff calculations, with data from IMF (2025b).
Note: The shaded area in Panel A represents the interquartile range (percentile 25th to 75th) of public debt distribution across Latin American and Caribbean countries. The figure does not include Argentina and Ecuador, for which data are not available; Argentina, however, has exhibited high volatility levels during the last five years shown. Under the current fiscal consolidation process, debt declines to 85 percent of GDP in 2025 from 125 percent in 2023. Projections for 2025 are based on IMF (2025b). The FISLAC risk threshold (54.8 percent of GDP) indicates the average level of debt at which the probability of falling into a fiscal crisis increases. The threshold is estimated following Valencia, Díaz, and Parra (2022) for 23 Latin American and Caribbean countries between 2000 and 2025p. The net debt change decomposition (Panel B) calculations also do not include Argentina and Ecuador. Debt change decomposition methodology takes the value of interest payment as a percentage of GDP as the contribution of interest to debt change. 2025p = 2025 projections.

The interquartile distribution of public debt points to a broad-based rise in vulnerabilities. While the regional average has remained above the median, the post-2019 narrowing of this gap suggests higher debt is increasingly widespread rather than concentrated in a few outliers.

Projections of debt dynamics for 2025 clarify the sources of the slowdown. Earlier gains were supported by temporary tailwinds from strong growth and high inflation, but these have weakened. Meanwhile, interest payments continue to rise, and primary deficits are reemerging.

Differences in debt drivers across lower- and higher-rated sovereigns reveal the distinct forces across the region that shape recent debt changes (Figure 4.1, Panel B). Lower-rated countries are running, on average, small primary surpluses, but they face outsized pressure from high and rising interest costs, which remain well above the

regional average.¹ Their debt reduction in 2025 is larger than for the region overall, but this is explained mainly by inflation rather than durable improvements in fiscal fundamentals. These conditions point to a key vulnerability: As inflation fades and growth remains modest, interest payments could become the dominant driver of debt dynamics (Ayres et al. 2025).

In higher-rated countries, the persistence of primary deficits remains an issue. Relative to lower-rated peers, they enjoyed more favorable financing conditions that have so far limited the near-term impact of higher interest costs. Completing the fiscal consolidation hinges, however, on maintaining credibility to avoid further increases in interest rate payments. A continued widening of primary deficits—alongside sustained increases in interest payments—would erode fiscal space and place renewed upward pressure on debt ratios.

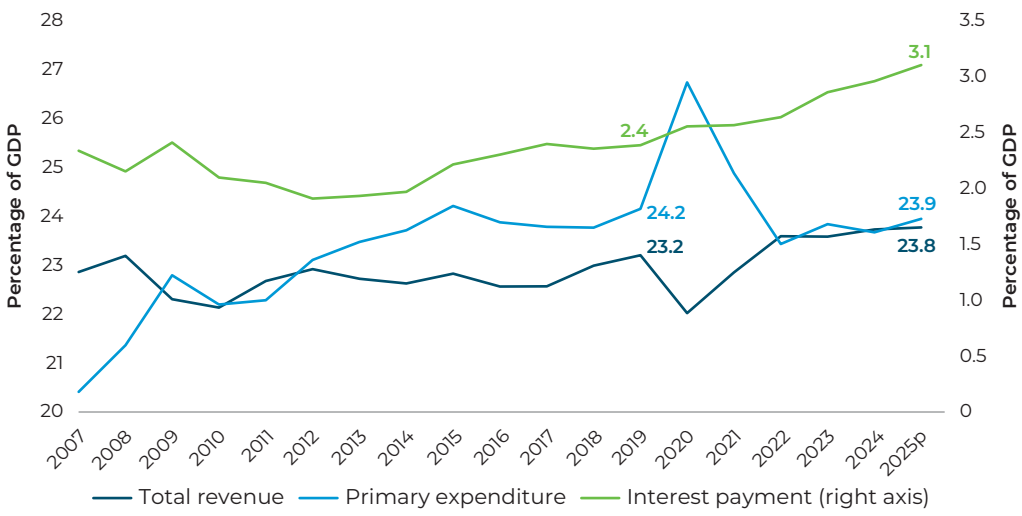
On average, primary balances remain broadly contained, but rising interest payments are the main source of fiscal pressure. Since 2022, total revenues and primary expenditures have moved within about one percentage point of each other, indicating a relatively narrow primary gap (Figure 4.2). By contrast, interest payments have increased steadily since 2012 and will surpass 3 percent of GDP in 2025, reaching their highest level in more than two decades.

Rising interest payments are expected after large debt issuances but also during periods of higher interest rates. Figure 4.3, Panel A, decomposes these forces and illuminates both the legacy of past borrowing and the region's growing sensitivity to global rates. More than half of today's debt-service burden (55 percent) would have materialized even if effective interest rates had remained at their 2021 levels, reflecting the pandemic-era surge in debt and earlier issuance. The remainder has been driven by higher effective interest rates (38 percent) and exchange rate movements (7 percent), both linked to the tightening of global financial conditions since 2021. Recent shifts in the U.S. yield curves and adjustments in sovereign borrowing strategies, discussed in Box 4.1, further illustrate the pressures that shape financing conditions in the region (see also Galindo et al. [2026]).

A complementary decomposition of year-to-year changes in interest payments (as a share of GDP) separates the roles of new borrowing, effective interest rates, and nominal GDP growth (Figure 4.3, Panel B). New debt issuance is the dominant driver, but the

¹ In 2020, countries with high and low sovereign credit ratings experienced a sharp increase in debt, although the rise was more pronounced among lower-rated countries, which peaked at about 80 percent of GDP, compared with 60 percent for higher-rated countries. Since then, debt levels in both groups have declined, but the adjustment has been much larger for lower-rated countries, which reduced debt from 80 percent to around 63 percent of GDP by 2025 (excluding Argentina). Higher-rated countries, in contrast, saw a more moderate decline and in 2025 average about 55 percent of GDP. Despite this narrowing difference, lower-rated countries continue to have a substantially higher interest burden.

FIGURE 4.2 • Revenues and Expenditures in Latin America and the Caribbean

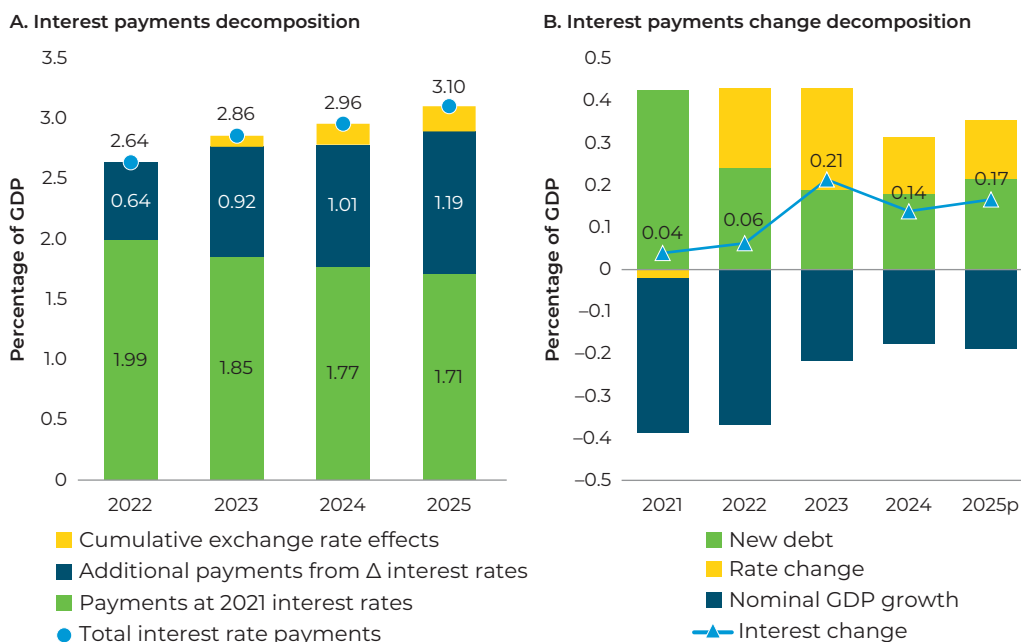


Source: IDB staff calculations, with data from IMF (2025b). Interest rate payments correspond to total servicing costs on domestic and external public debt.
Note: Simple average. Projections for 2025 are based on IMF (2025b). Figure does not include Ecuador.
2025p = 2025 projections.

contribution of higher effective interest rates has increased steadily since 2021—especially in 2022–23—as higher rates were applied to a larger debt stock and transmitted tighter global monetary policy. Although nominal GDP growth has helped cushion these pressures, this offset has weakened over the past two years. With both real activity and inflation expected to moderate, the region cannot rely on them to contain debt dynamics.

In 2025, fiscal balances across the region were shaped primarily by movements in revenues, while expenditure levels and composition remained broadly stable in countries undertaking consolidation. As Figure 4.4 shows, most countries that improved their fiscal positions did so through higher revenues—most notably Panama and Guyana, where strong income growth supported tax collections. By contrast, countries with weaker balances typically experienced declining revenues or rising spending pressures. In Bolivia and Haiti, revenue losses more than offset stable or lower spending, leading to a sharp widening of deficits. In Guatemala, Brazil, and, especially, Suriname, deterioration was driven primarily by higher expenditures, despite revenue growth. These patterns show that durable consolidation requires expenditure discipline alongside revenue performance.

Spending composition has changed little in 2025. Current expenditure continues to dominate, reflecting rigidities in wages, transfers, and interest payments, while capital spending remains broadly stable. The experiences of the different countries nevertheless reveal recurring concerns about the quality of adjustment. In Barbados, Mexico, and Panama, expenditure reductions have been concentrated in cuts to public investment. In Brazil, Guyana, Suriname, and Trinidad and Tobago, higher spending has been

FIGURE 4.3 • Breakdown of Interest Payments

Source: IDB staff calculations, with data from IMF (2025b).

Note: In Panel A, a standard debt dynamics approach is applied to separate the effect of increases in effective interest rates, holding constant the observed primary balance, GDP growth, and exchange rate valuation effects. The lowest portion of each bar represents the level of interest payments that would prevail if the effective interest rate had remained at its 2021 value, while the part above captures the cumulative effect of rate increases since 2021. In Panel B, the decomposition of changes in interest payments as a share of GDP follows the standard identity:

$$\Delta \left(\frac{I}{Y} \right)_t = \frac{r_{t-1} * \Delta D_{t-1}}{Y_t} + \frac{D_{t-1} \Delta r_t}{Y_t} - \left(\frac{I_{t-1}}{Y_t} \right) \left(\frac{\Delta Y_t}{Y_t} \right)$$
 where I denotes interest payments, D the debt stock, r the implicit interest rate, and Y nominal GDP. The first term captures the effect of changes in debt stocks ("new debt"), the second isolates the effect of changes in interest rates, and the third reflects the impact of nominal GDP growth on the interest-to-GDP ratio. The implicit rate is defined as $r_t = \frac{I_t}{D_{t-1}}$. Projections for 2025 are based on IMF (2025b). The figures do not include Ecuador. 2025p = 2025 projections.

driven mainly by current outlays and interest payments.² Only El Salvador has recorded a substantial decline in current expenditure, and only Belize and Guatemala have seen an increase in capital spending. Overall, these patterns suggest that fiscal space is often wasted on expansions of current spending during upswings, while investment is disproportionately compressed during consolidation episodes.

Recent fiscal outcomes have continued to hinge on revenue performance. Since 2021, revenue growth in the region has been modest and driven largely by inflation rather than stronger real activity or durable gains in tax administration. Given the central role of revenues in consolidation and debt stabilization—and the limited scope for raising statutory tax rates—ongoing digitalization of tax administrations offers a promising channel to strengthen collection capacity (Box 4.2).

² In recent years, Guyana and Panama have recorded public investment levels above the regional average. However, the fiscal consolidation process over the past year has relied in part on cuts to public investment.

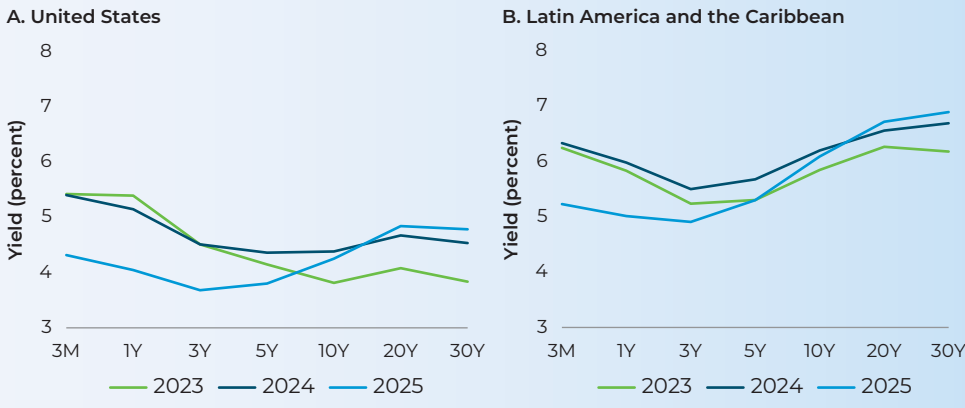
BOX 4.1 • Navigating Movements in the U.S. Yield Curve: Take the Short Route

Between 2022 and 2025, financing conditions for Latin America and the Caribbean were shaped by the normalization of the U.S. Treasury yield curve. Following the 2021 inflation surge, the United States moved through a monetary tightening cycle—initially expected to be short lived—followed by an easing phase toward a higher post-pandemic neutral rate (r^*). As a result, the yield curve shifted from pronounced inversion in 2023 to a flatter profile in 2024 and an upward slope by 2025 (Figure B4.1.1, Panel A). Because U.S. Treasuries are the key benchmark for dollar-denominated sovereign debt, this transition altered the external term structure faced by issuers in the region and repriced risk across maturities in international markets.

Specifically, external yield curves moved broadly in tandem with U.S. benchmarks (Figure B4.1.1), especially at the lower end of the yield curve. Major issuers—Brazil, Chile, Colombia, Mexico, and Peru—saw a marked steepening of their dollar yield curves, with short-term yields easing as the global inversion unwound, while long-term rates increased, consistent with higher term premia and greater uncertainty about the long-run level of risk-free rates. In response, sovereigns adjusted issuance toward the short and medium segments of the curve, where financing conditions were relatively more favorable.

Issuance data confirm this portfolio rebalancing (Figure B4.1.2, Panel A). The average tenor of newly issued or reopened dollar bonds fell by more than twelve years between 2021 and 2025, reflecting an effort to avoid locking in high long-term rates.^a Counterfactual comparisons (Figure B4.1.2, Panel B) suggest that, had countries maintained the longer maturity profile typical of 2021–22, effective borrowing costs would have been higher. The observed shift toward shorter maturities reduced effective yields on new external issuance by around 50 basis points.

FIGURE B4.1.1 • Yield Curves

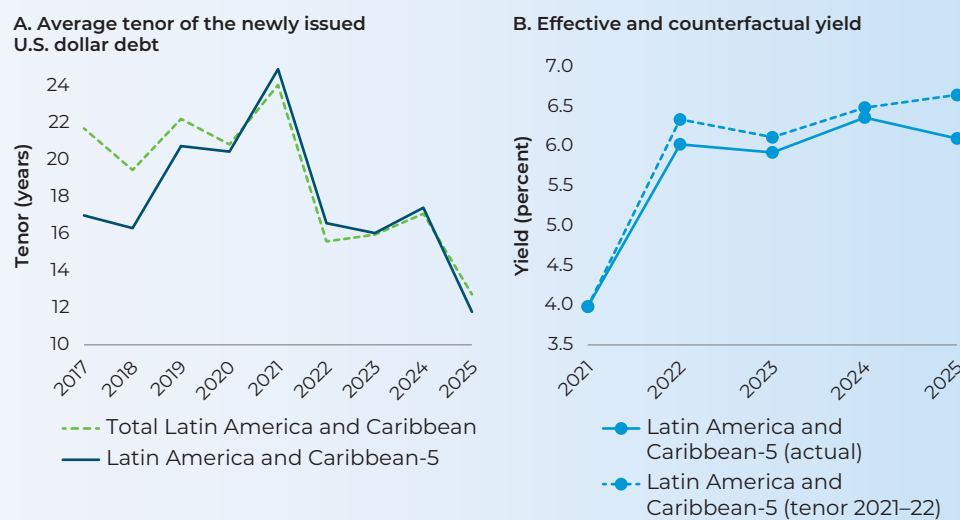


Source: IDB staff calculations, with Bloomberg data.
Note: The Latin America and Caribbean yield curve corresponds to the simple average of the sovereign U.S. dollar-denominated yield curves of Brazil, Chile, Colombia, Mexico, and Peru, computed as of June 30 of each year.

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BOX 4.1 • Navigating Movements in the U.S. Yield Curve: Take the Short Route *(continued)*

FIGURE B4.1.2 • Tenor Trends and Sovereign Financing Costs in Latin America and the Caribbean



Source: IDB staff calculations, with Bloomberg data.

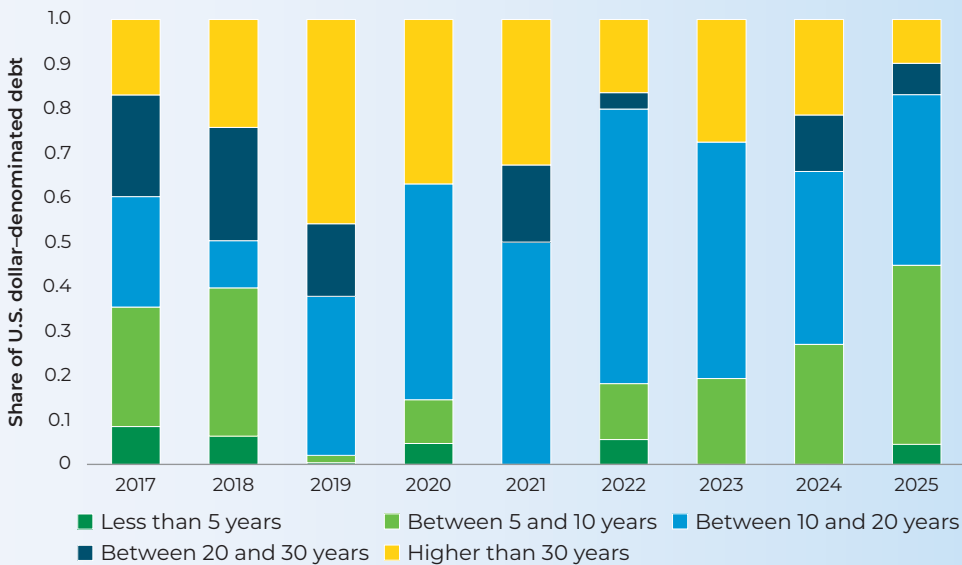
Note: The figure in Panel A displays the average tenor (in years) at the time of issuance for new and reopening U.S. dollar-denominated sovereign bonds placed in international markets. *Total Latin America and Caribbean* corresponds to the simple average across all Latin American and Caribbean sovereign issuers, while *Latin America and Caribbean-5* corresponds to the simple average across Brazil, Chile, Colombia, Mexico, and Peru, as of September 15, 2025. The methodology underlying Panel B consists of calculating the weighted average tenor—using amounts issued as weights—for Brazil, Chile, Colombia, Mexico, and Peru and deriving the effective yield using the corresponding Latin America and Caribbean-5 U.S. dollar sovereign yield curve shown in Figure B4.1.1. (solid line). The counterfactual yields (dotted line) are computed by applying the simple average of the 2021–22 tenors to the linear interpolation of the yield curves, yielding the theoretical rates at which these countries would have issued had they maintained maturities constant at those levels.

Figure B4.1.3 shows that the compression in average maturity has been driven mainly by a rebalancing from very long-term instruments (over 20 years) toward medium-term bonds (5–10 years), rather than a shift into very short-term securities (less than 5 years). This approach has helped contain near-term rollover risks, as most amortizations from recent issuance are scheduled beyond the next five years. At the same time, the clustering of obligations in the medium term increases the importance of credible and sustainable medium-term fiscal frameworks to anchor expectations, support refinancing on favorable terms, and prevent roll-over pressures from reemerging as these bonds approach maturity.

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BOX 4.1 • Navigating Movements in the U.S. Yield Curve: Take the Short Route *(continued)*

FIGURE B4.1.3 • Share of U.S. Dollar-Denominated Debt Issued, by Maturity of the Debt

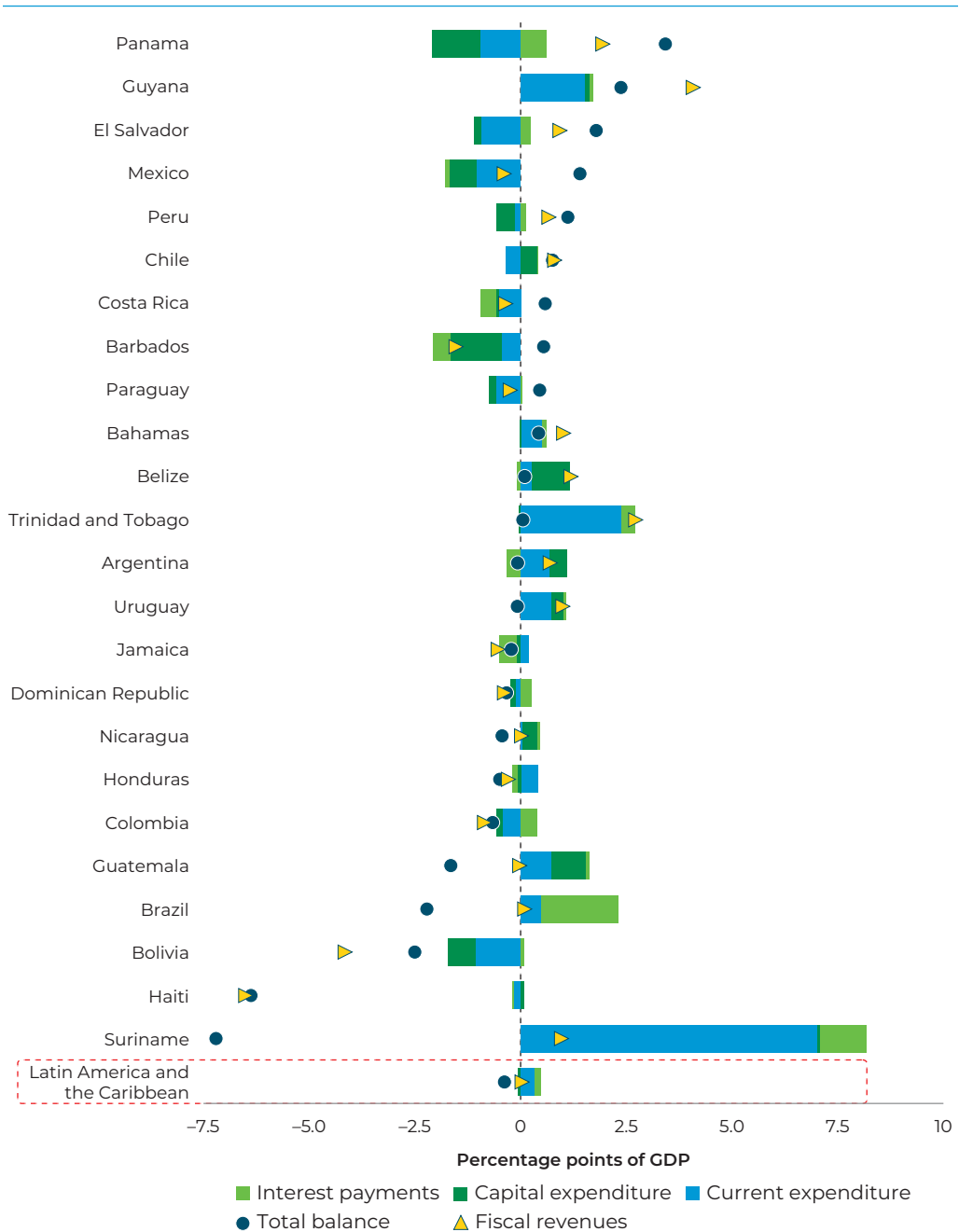


Source: IDB staff calculations, with Bloomberg data.
Note: The figure shows the share of U.S. dollar-denominated bond issuances by Latin American and Caribbean countries in international markets, classified into five categories by maturity at issue. Maturity ranges include the upper bound; for example, less than 5 years includes bonds with 5- or less than 5-year tenors. The lower portions of the bars are associated with shorter- and medium-term maturities, while the upper parts represent long-term issuances.

^a Tenor refers to the remaining lifespan of a financial contract.

As the temporary forces that supported earlier improvements have faded, consolidation has stalled. Revenue growth has slowed with the dissipation of growth and inflation-related windfalls from 2021 to 2022, while underlying tax performance remains subdued. On the spending side, rigidities constrain short-run adjustment, and, in several countries, consolidation has relied on compressing capital expenditure—an approach that is neither sustainable nor supportive of growth. In some cases, these challenges are further compounded by spending inefficiencies that generate not only fiscal pressures but broader macroeconomic effects on exchange rates, inflation, and growth.³ Going forward, progress will require strengthening revenue capacity while overcoming political economy constraints to address structural pressures in current spending (Arce et al. 2025).

³ For further analysis on this issue, see Chapter 4 of Ayres, Izquierdo, and Parrado (2025).

FIGURE 4.4 • Decomposition of the Changes in the Total Fiscal Balances across the Region

Source: IDB staff calculations, with data from IMF (2025b).

Note: Projections for 2025 are based on IMF (2025b). The figure does not include Ecuador.

BOX 4.2 • The Fiscal Benefits of Digitalization: What We Have Learned So Far

As they seek to promote compliance, tax authorities in Latin America and the Caribbean are impeded by longstanding structural challenges. A large informal sector allows firms and households to move into the shadows if they perceive oversight as too stringent or the benefits of formality as too limited. At the same time, the domination of taxpayer bases by small contributors increases monitoring costs relative to expected revenue gains. These challenges are compounded by limited administrative capacity, which forces highly selective enforcement.

Against this backdrop, the digitalization of tax records can strengthen both voluntary compliance and compliance resulting from more effective enforcement. Digital tools reduce the cost of monitoring, outreach, and enforcement actions while improving recordkeeping, filing, and payment processes. Below is presented recent peer-reviewed evidence on the fiscal effects of digitalization initiatives in the region, drawing on evaluations of flagship programs, such as PROFISCO in Brazil; electronic invoicing systems; and digital tax record platforms that expand third-party reporting to detect noncompliance. The review focuses on nonexperimental settings, with results summarized in Table B4.2.1.

The evidence indicates that digitalization is highly effective at detecting noncompliance. Across countries and tax instruments, digital tools consistently uncover large disparities between reported and detected taxable obligations, with strong detection capacity across tax types. In Latin America and the Caribbean, two interventions stand out: electronic invoicing and the digitalization of annual tax records, both of which enable third-party reporting. These tools have been particularly effective for value-added tax (VAT), where the invoice-credit mechanism creates offsetting incentives; sellers may underreport sales to reduce liabilities, while buyers have incentives to report purchases to claim credits. Electronic invoicing leverages this structure by creating a real-time, traceable record of transactions, enabling systematic cross-checks between sales and purchases and strengthening incentives for truthful reporting. Evaluations of phased rollouts in Brazil and Peru document higher reported activity alongside lower compliance costs. Third-party reporting based on digital annual records has also improved detection—illustrated by experiences in Chile and Costa Rica—even beyond VAT and in contexts without universal e-invoicing.

Digitalization is not a magic solution, however. Detection capacity and enforcement credibility are distinct challenges, and without credible follow-up mechanisms and appropriate legal frameworks, net revenue gains from digital investments remain limited. Studies show that even when discrepancy is identified, tax authorities often lack the capacity to pursue all cases, and taxpayers may respond by offsetting detected liabilities through other margins of declaration. Documented responses include inflated cost reporting (Brazil), expanded use of VAT credits (Chile), and additional administrative expense claims (Ecuador). As a result, studies that assess digitalization in isolation typically find limited net revenue impacts.

To address this issue, some countries have experimented with combining digital tools with massive audit strategies, with PROFISCO in Brazil a prominent example. The program combines digital detection with a range of enforcement instruments, such as text messages, letters, in-person visits, and audits. Evidence suggests that the most effective tools to reduce noncompliance—in-person audits—are generally cost effective only for larger firms. For medium and smaller taxpayers, lower-cost instruments (text messages, emails) tend to be more efficient, but they typically leave a substantial portion of noncompliance unresolved. To be effective, digitalization needs to be paired with enforcement strategies calibrated to taxpayer size and risk profiles.

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BOX 4.2 • The Fiscal Benefits of Digitalization: What We Have Learned So Far *(continued)*

TABLE B4.2.1 • Summary of the Results

Topic	Tax revenue increase	Tax base increase	Taxpayer offsetting adjustments	Country
Electronic billing and reporting system	US\$2.53 billion	US\$3,820 per firm	Adjustment in reported expenses	Brazil
	US\$0	US\$7,810	Offset via existing VAT credits	Peru
	US\$298	US\$506	Offset via existing VAT credits	Peru
Electronic payment of taxes	US\$0	US\$0		Uruguay
Use of information (third-party reporting)	US\$2.7	US\$16.8		Chile
	US\$482 per firm	US\$804 per firm		Costa Rica
	US\$15–US\$18 per firm	↑ 22 percentage points filing rate, of which ↑ 4.8 percentage points probability positive net liability	Offset via cost deductions with firms declaring zero in their liabilities	Costa Rica
	US\$1,851 per firm out of US\$39,736*	US\$5,852 per firm out of US\$187,358*	Offset via cost deductions: “other administrative costs” and nonresponse	Ecuador
Effectiveness of massive auditing systems**	US\$429–US\$1,486 per firm	US\$1,229 per firm		Brazil
	US\$1,347 per firm	US\$1,417 per firm	Adjustment via composition of taxable revenue	Brazil
	US\$2,577 per firm	US\$3,580 per firm		Brazil

Source: IDB staff calculations, based on Naritomi (2019); Bellonet al. (2022); Bellon, Dabla-Norris, and Khalid (2023); Brockmeyer and Sáenz Somarriba (2025); Pomeranz (2015); Brockmeyer and Hernández (2016); Brockmeyer et al. (2019); Carrillo, Pomeranz, and Singhal (2017); Motta Café, Yarygina, and Escalante (2024); Bando Grana et al. (2021); and Yarygina et al. (2025).

Note: The table summarizes the potential effects of digitalization on tax revenue in Latin American and Caribbean countries. Due to heterogeneous country contexts, interventions, and outcome variables, additional calculations were required beyond those reported by the authors, using their results and descriptive statistics. In the table, the column labeled “Tax revenue increase” indicates the net increase in tax revenues resulting from digitalization; “Tax base increase” indicates the expansion of the tax base—that is, the portion of economic activity subject to taxation; and “Taxpayer offsetting adjustments” indicates adjustments made by taxpayers that may reduce the net effect on revenues.

*Estimates correspond to the hypothetical scenario in which no offset occurs, and all firms respond.

**A massive auditing system involves cross-checking information from declarations and payments with other sources (both internal and third-party), notifying taxpayers of irregularities, and providing an interface either to regularize inconsistencies or dispute the notification.

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BOX 4.2 • The Fiscal Benefits of Digitalization: What We Have Learned So Far *(continued)*

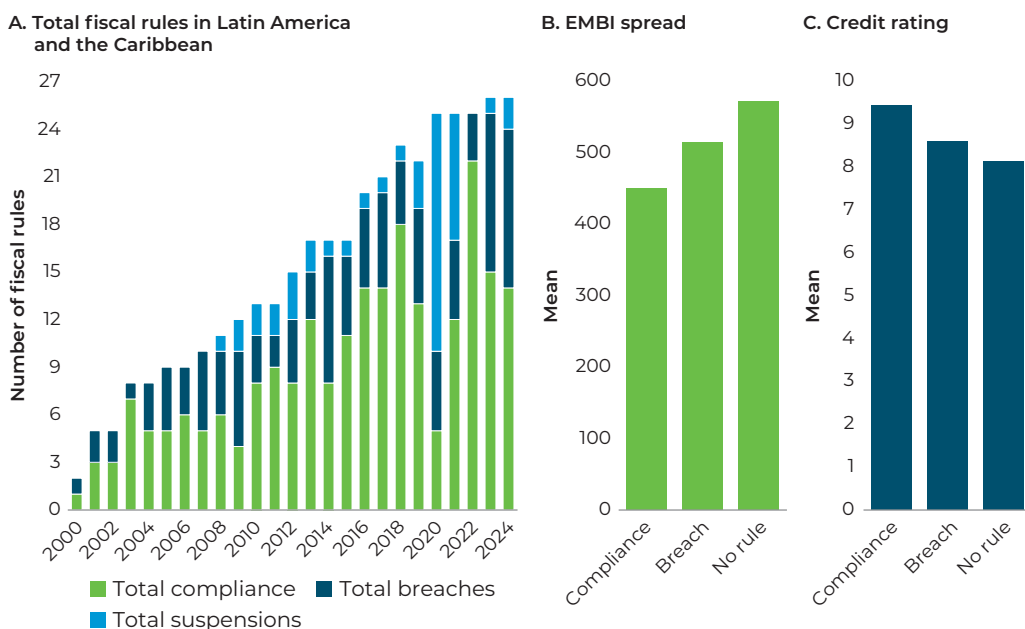
Beyond immediate revenue effects, digitalization can generate broader behavioral and productivity gains. Uruguay's adoption of electronic VAT payment systems was associated with a sharp increase in the use of credit and debit cards, consistent with reduced incentives to avoid traceable transactions. Similarly, electronic invoicing can propagate digital practices along production networks, supporting wider technological diffusion. While these effects are not always reflected in short-run revenue, they represent positive externalities for financial deepening and longer-run growth.

The Importance of Fiscal Rules

In a more uncertain global environment, fiscal rules are increasingly important as countercyclical anchors. Their effectiveness depends not simply on their legal adoption but on predictable and consistent implementation.⁴ Figure 4.5, Panel A, shows that Latin America and the Caribbean has broadly mirrored the global expansion of fiscal rules, but recent experience also illustrates how credibility can weaken when compliance deteriorates (Arce and Villa 2025). Suspensions and modifications that increased during and immediately after the pandemic reflected the legitimate use of escape clauses under exceptional conditions. Recurrent or insufficiently justified use, however, can erode the framework. In the last two fiscal years, compliance has fallen and is now below pre-2020 levels, with many deviations taking the form of outright breaches rather than transparently managed temporary exemptions.

Differences in fiscal rule compliance are also reflected in market perceptions, with direct implications for borrowing costs. Panels B and C of Figure 4.5 show that countries meeting fiscal rule targets tend to display lower sovereign spreads and stronger credit ratings. Countries in breach face higher financing costs, while those without rules perform slightly worse on average. These patterns point to the value of credible and well-implemented fiscal frameworks, which help anchor expectations and support more favorable financing conditions, especially in periods when global financial markets are tighter.

⁴ In general, an asymmetrical response of compliance to macroeconomic conditions can be observed: While compliance decreases during bad times, it does not improve in good ones (Ardanaz, Ulloa-Suárez, and Valencia 2024). To achieve a countercyclical position, well-designed fiscal rules are needed (Andrian et al. 2024).

FIGURE 4.5 • Fiscal Rules, Compliance, Sovereign Spreads, and Credit Rating Dynamics

Source: IDB calculations, based on the Latin American and Caribbean Compliance Hub.

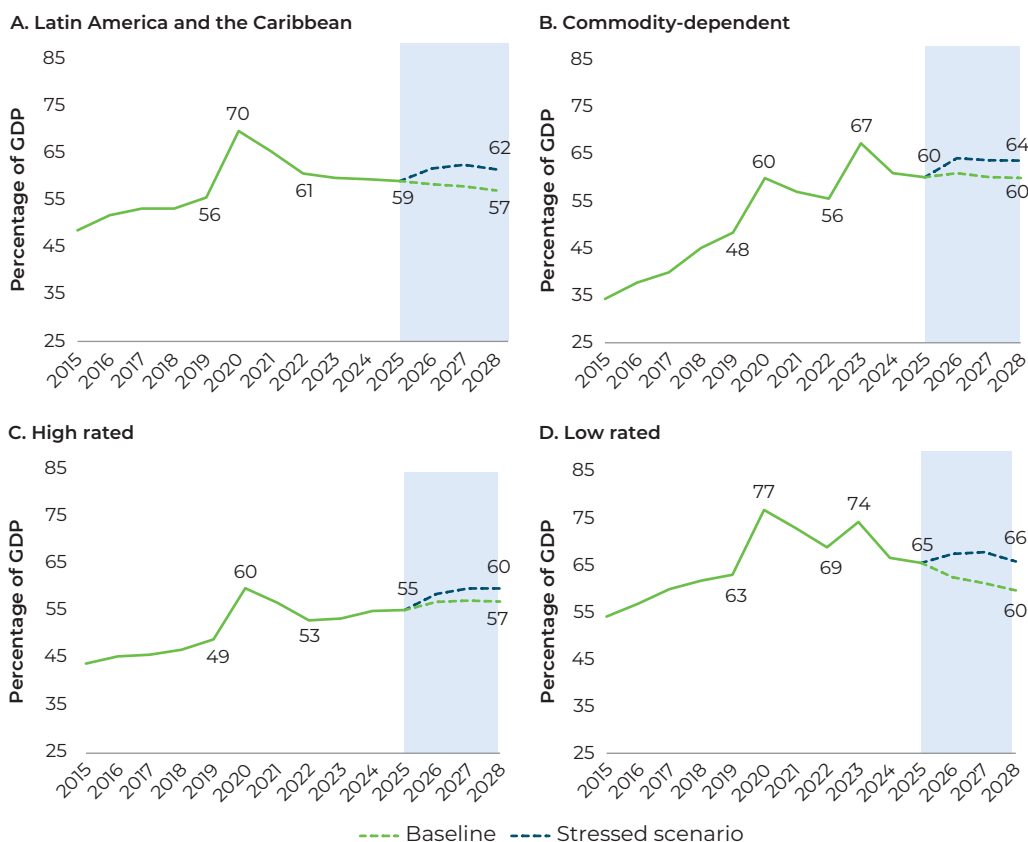
Note: In Panel A, escape clauses are treated as suspensions. Panel B reports t-tests comparing mean differences across groups—namely, the existence of fiscal rules and, among countries with rules, compliance versus noncompliance. The exercise is inspired by Ardanaz, Ulloa-Suárez, and Valencia (2024).

Risks: Exposure to Rising Borrowing Costs and Weaker Growth

This section models the macrofiscal risks encountered by Latin America and the Caribbean during the period 2025–28, embedding them within the global dollar cycle and the “risk-off” dynamics that were discussed in Chapter 3. The stressed scenario tests the resilience of public finances to a simultaneous and severe deterioration in external conditions. It captures a sequence of mutually reinforcing shocks: risk-off dynamics leading to dollar strength, which in turn tightens global financial conditions, triggers exchange-rate depreciation, and, ultimately, worsens debt dynamics. Because commodity-dependent countries are highly exposed to price volatility, a price shock is simulated,⁵ reducing terms of trade and eroding fiscal revenues in these economies. Together these shocks illustrate how macrofinancial conditions can destabilize debt trajectories in the region.

The exercise shows that the regional debt trajectory remains fragile and highly dependent on external financial conditions. Relative to the baseline, the ratio of public debt to GDP declines only modestly by 2028, underscoring the protracted nature of

⁵ A decline of one-half standard deviation in the International Monetary Fund commodity price index.

FIGURE 4.6 • Scenarios for Debt

Source: IDB staff scenarios and calculations, using data from IMF (2025b).

Note: Groups include all IDB-borrowing countries except Venezuela. Commodity-dependent countries include Argentina, Bolivia, Chile, Ecuador, Guyana, Paraguay, Peru, Suriname, Trinidad and Tobago, and Uruguay. High-rated countries include Brazil, Chile, Costa Rica, the Dominican Republic, Guatemala, Jamaica, Mexico, Panama, Paraguay, Peru, Trinidad and Tobago, and Uruguay. Low-rated countries include Argentina, Barbados, Belize, Bolivia, Colombia, Ecuador, El Salvador, Guyana, Haiti, Honduras, Nicaragua, Suriname, and the Bahamas.

post-pandemic consolidation. Under the stressed scenario, this limited improvement is reversed, with debt rising by about 5 percent of GDP by 2028—a result that highlights the sensitivity of public finances to global shocks.

Commodity-dependent economies face a more challenging outlook even in the baseline. Debt ratios are projected to remain around 60 percent of GDP in the near term, reflecting weaker buffers. Under stress, the combined impact of lower commodity prices and a sharp rise in borrowing costs increases debt by about 4 percent of GDP by 2028, illustrating acute exposure to volatility in terms of trade and reliance on external financing.⁶

⁶ A notable exception is Guyana, where prudent management of the recent oil-revenue windfall is expected to keep debt dynamics contained, with the debt-to-GDP ratio stabilizing around 30 percent by 2030 even in a stressed scenario.

Outcomes also differ markedly by credit rating. In the baseline, lower-rated sovereigns reduce debt faster than higher-rated peers, albeit from higher initial levels. Under a risk-off shock, however, vulnerabilities become evident: Debt deviations from baseline are substantially larger for low-rated countries, while high-rated countries experience more contained increases. This divergence reflects differences in fiscal space and the greater sensitivity of lower-rated borrowers to Emerging Markets Bond Index (EMBI) spreads and financing costs.

Finally, the rising incidence and severity of natural disasters is an increasing medium-term risk to fiscal stability in the region. As mentioned in previous reports, severe hurricanes, for example, generate sizable and persistent fiscal costs for Central America and the Caribbean (Cavallo et al. 2024). On average, public debt is about 18 percent higher three years after a severe storm than had been implied by pre-storm trends.

Jamaica's recent experience offers practical lessons on how to mitigate these risks. A Category 5 hurricane made landfall in October 2025 while the country was still recovering from a Category 4 storm that took place in July 2024. The Global Rapid Damage Estimation (GRADE) study conducted by the Inter-American Development Bank and World Bank placed the total damage at 41 percent of GDP. Nevertheless, as of this writing, Jamaica is not expected to see its debt-to-GDP ratio rise above its current level of about 60 percent. This outcome reflects over a decade of deep and sustained institutional and policy reform, including a track record of strong fiscal discipline—including primary surpluses of over 6 percent of GDP since 2014—and a multilayered disaster risk financing strategy featuring catastrophe bonds, insurance, contingent credit lines with multilaterals, and a National Disaster Reserve Fund. Overall, Jamaica's example demonstrates that prudent reforms and credible fiscal frameworks, combined with prearranged and diversified risk-financing instruments, can help countries absorb even large disasters without destabilizing future debt dynamics.

Looking Ahead

Fiscal policy in Latin America and the Caribbean is in a challenging phase. Debt remains above pre-2020 benchmarks, interest payments are rising, and the temporary forces that supported early consolidation have dissipated. At the same time, exposure to global financial shocks means that adverse external conditions can quickly reverse recent gains and place debt back on an upward path. Beyond external conditions, domestic political dynamics can also increase sovereign risk. In 2026, Brazil, Colombia, Costa Rica, Haiti, and Peru will hold presidential and/or legislative elections, potentially elevating policy uncertainty. Strengthening fiscal fundamentals is, therefore, urgent. A credible medium-term fiscal framework should also account for the monetary policy stance. In countries where policy remains restrictive despite inflation being on target, the expected easing cycle provides an opportunity to advance fiscal consolidation with lower output costs.

Completing the fiscal consolidation will require durable revenue improvements, containment of rigid current spending, and protection of public investment crucial for long-run growth. Managing borrowing costs will also require more active debt-maturity strategies that reduce refinancing risks and limit sensitivity to abrupt global repricing. Credible fiscal rules can provide a countercyclical anchor, but their effectiveness depends on consistent implementation, transparent use of escape clauses, and stronger enforcement. Digital tools can improve revenue collection and monitoring, but they are complements to—not substitutes for—credible enforcement, sound institutions, and robust medium-term fiscal frameworks. Progress on these fronts is central to rebuilding fiscal space, reinforcing market confidence, and strengthening resilience amid heightened global uncertainty.

CHAPTER 5

Challenges for Monetary Authorities in Latin America and the Caribbean

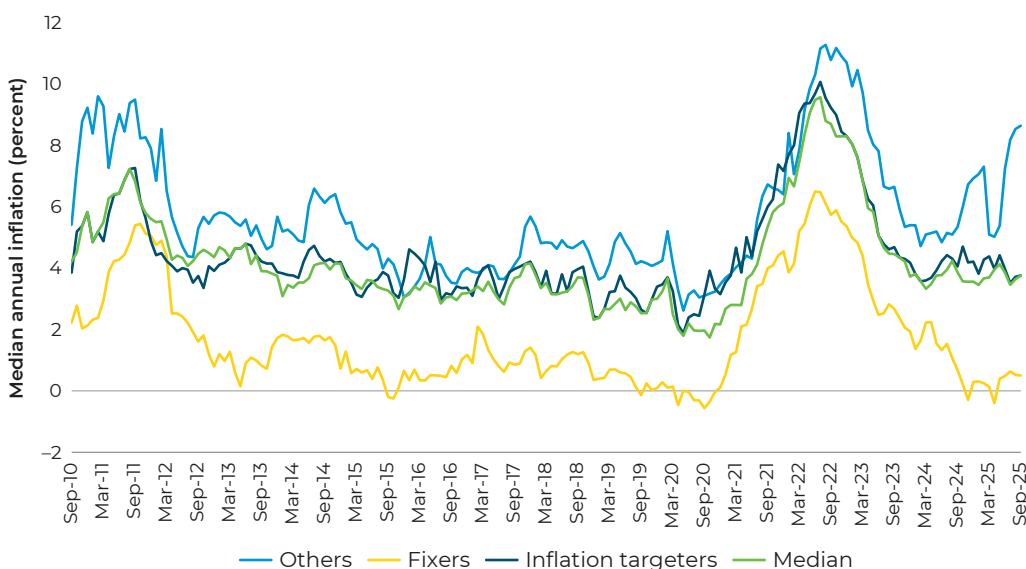
Following a successful disinflationary process, Latin American and Caribbean countries now must contend with new challenges derived from supply and demand shocks that occurred in previous years. These major shocks may have left scars that can threaten monetary stability in the future, as many economic agents have experienced levels of inflation not seen in generations.

Expectations and trust in economic authorities are key to ensuring macroeconomic stability. This chapter discusses how the recent macroeconomic experience can affect individuals' behavior. This change in behavior can diminish the effectiveness of conventional monetary policy instruments. Additionally, it discusses how new financial instruments can reduce the cost of indexation in foreign currency and how higher inflation and monetary uncertainty experienced by individuals can provide incentive to use assets denominated in foreign currencies. Recommendations based on these findings culminate in an overall conclusion: Monetary authorities can combine policies that allow them to anchor expectations and ensure monetary stability, while keeping on hand flexible tools to absorb future external negative shocks.

Divergent Inflationary Patterns after a Successful Disinflation

Following a successful disinflationary process in most countries in the region, there are now divergent inflation patterns in Latin America and the Caribbean. To organize this analysis, the region's countries are divided into groups based on their monetary policy regimes. Figure 5.1 refers to these groups as “inflation targeters,” “fixers,” and “others” and shows for each of these groups the median inflation from 2010 until the time for which the most recent data are available.

The inflation targeters—those economies in the region with inflation-targeting regimes—have experienced stable inflation since 2024. In the median economy, inflation has returned to target. Challenges related to inflationary or deflationary pressures and output appear modest compared to the ones these economies faced in previous periods.

FIGURE 5.1 ● Inflation in the Region

Source: Haver Analytics and IDB staff calculations.

Note: Twelve-month inflation was calculated using monthly data from January 2010 to September 2025. The country group classification follows the International Monetary Fund's Annual Report on Exchange Arrangements and Exchange Restrictions 2022 (AREAER, IMF 2023). "Fixers" include the Bahamas, Barbados, Belize, Ecuador, El Salvador, and Panama. "Inflation targeters" are Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Guatemala, Jamaica, Mexico, Paraguay, Peru, and Uruguay. The "others" category encompasses Argentina, Bolivia, Guyana, Haiti, Honduras, Nicaragua, Suriname, and Trinidad and Tobago.

The fixers—the countries with fixed exchange rates—exhibit low and stable inflation. This pattern was also observed in the period following the global financial crisis, but during that time U.S. inflation was also relatively low. As of this writing, inflation in the United States has remained above the Federal Reserve target of 2 percent, increasing the inflationary gap between it and the median economy among the fixers. This lower inflation could be a sign of economic slack. As monetary policy tools are restricted in economies with fixed exchange rates, future shocks can pressure the fiscal side. Despite these risks, these economies have generally been successful in controlling inflation and maintaining economic stability, though addressing fiscal vulnerabilities is still advisable.

Finally, the "others"—economies with alternative monetary policy regimes—see greater inflation heterogeneity. In some, inflation has been rising rapidly, while others have made significant progress. Many of these economies are facing renewed inflationary pressures.

Overall, the objective for Latin American and Caribbean economies should be to return to their explicit or implicit inflation targets. This applies not just to those with high inflation, the cost of which is well known and widely discussed. Many economies have inflation below their targets, which can lead to a de-anchoring of expectations and

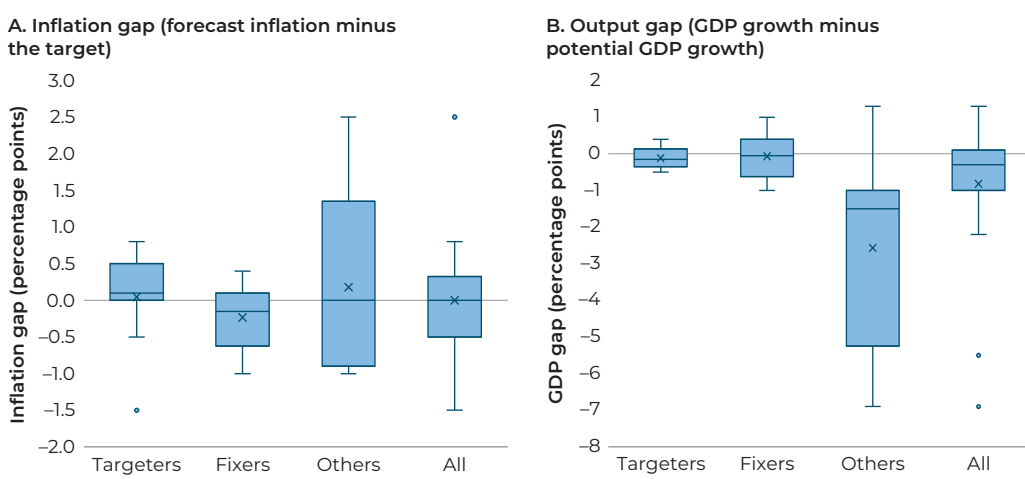
appreciation of their currency in real terms. With many sources of uncertainty rising globally, it is particularly important to return to a neutral stance as quickly as possible, so that monetary authorities can act promptly if some of these sources materialize.

To illustrate the scale of the challenges the different groups may encounter, this chapter includes estimations of output and inflation gaps in Latin American and Caribbean economies expected to pertain by the end of 2026.¹ Figure 5.2 shows the dispersion in terms of the inflation gap (that is, the forecast inflation minus the target) and the output gap (GDP growth minus potential GDP growth) for each of the countries in the region where such an analysis is possible.

Panel A of Figure 5.2 shows that most economies with inflation targets are expected to have positive but moderate inflation gaps, with the median economy presenting none. Exchange rate fixers are also expected to have moderate inflation gaps, leaning more toward the negative. Gaps for these economies are generally more dispersed, but low. They contrast with the forecast for many economies that have alternative monetary policy regimes. In the latter's case, inflation gaps are more dispersed, with some sizably positive.

In terms of output, Panel B of Figure 5.2 shows heterogeneity among economies with different monetary policy regimes. In general, economies with inflation targets consistently have small output gaps. They are reaching a stable point in terms of output or

FIGURE 5.2 • Gaps and Policy Framework



Source: IDB staff calculations.

Note: Each boxplot summarizes the cross-country distribution of the inflation gap (Panel A) and the GDP gap (Panel B) for the economies classified as "inflation targeters," "fixers," and "others," as well as for the full sample. The boxes show the interquartile range; the horizontal line inside each box is the median; the "x" marker is the mean; the "whiskers" indicate the range, excluding outliers; and the dots denote the remaining observations.

¹ These gaps are estimated for countries where inflation targets can be explicitly or implicitly estimated by combining information from several sources for each country, including international institutions, local central banks, and private forecasters.

inflation gaps, which suggests they need strong policy actions to address issues related to business cycle fluctuations. Returning to a neutral stance for their policy rates can help them be prepared for future contingencies.

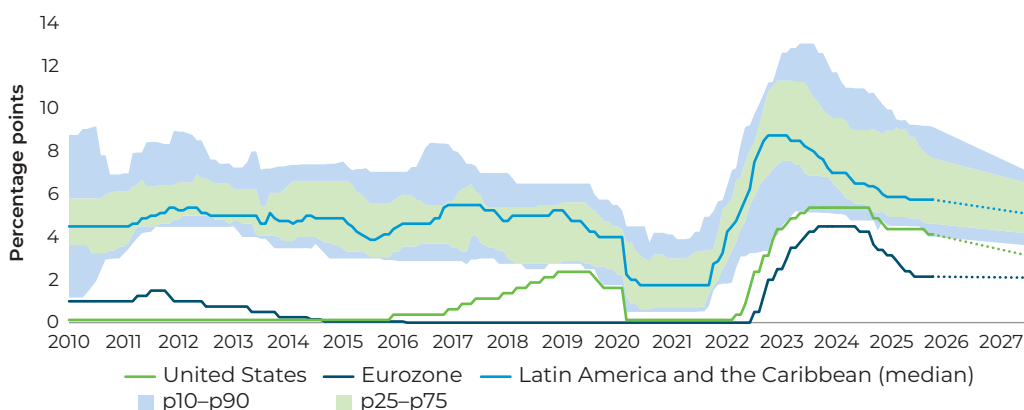
Economies with fixed exchange rates are in a similar situation, with slightly more dispersion. Their relatively stable economic stance provides an important opportunity to rebuild buffers. These economies rely strongly on fiscal instruments to perform counter-cyclical policies, so reducing fiscal deficits and overall debt levels is particularly important in this context.

Unlike the first two groups, many economies with alternative monetary policy regimes have large output and inflation gaps. The existence of these large gaps suggests there is space for monetary actions to address the inflationary and growth issues and achieve stability. The gaps also illuminate the important challenges these monetary authorities face in terms of economic stability, with policy tradeoffs that are particularly costly. In economies with large negative output gaps and positive inflation gaps, clearer monetary policy rules and management of expectations can be powerful tools to achieve lower inflation and output stabilization (Coibion et al. 2020; Hazell et al. 2022).

Global and Domestic Policy Interest Rates

When inflation began to pick up globally, countries in Latin America and the Caribbean increased policy rates earlier than the euro area and the United States, supporting a faster disinflation process. At this writing, policy rates remain high compared to pre-pandemic levels, as shown in Figure 5.3; they are expected to return to pre-pandemic levels by 2027. In the United States, policy rates are expected to decrease over the next two years but remain above the level that pertained after the global financial crisis. In the Eurozone, rates are not expected to decline much, remaining above pre-pandemic levels.

Interest rates in the Eurozone and the United States are expected to remain higher than in the previous decade for several reasons. For one, estimates by Ferreira, Lott, and Richards (2025) of real-time, long-term neutral rates find an upward trend in the United States. In the short run, the inflation gaps in the United States and other larger economies remain positive, pushing monetary authorities to maintain some level of monetary policy tightening until their inflationary pressures are released. In the region's economies, inflation gaps are relatively small. Nevertheless, nominal rates remain relatively elevated, so real policy rate gaps between them and the United States have increased further. Many economies in the region don't need a restrictive policy stand. Even if the difference in policy rates with the United States increases, economies with small gaps have space to return to a neutral stance. In some cases, even an expansionary stance may be necessary to reduce negative inflation gaps.

FIGURE 5.3 • Policy Rates in the Region

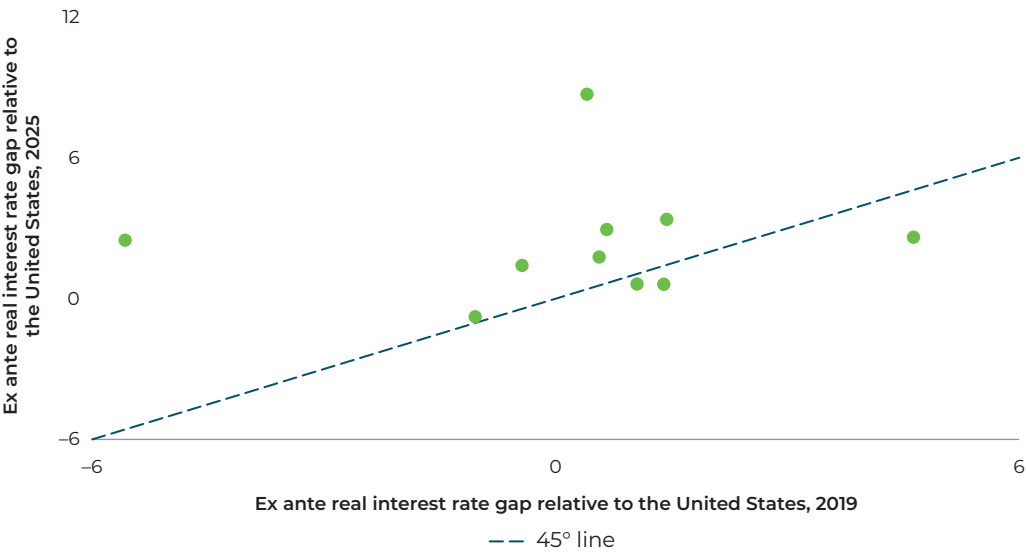
Source: IDB staff calculations, based on data from central banks and Haver Analytics.

Note: Median policy rate, inflation rate, and expected inflation for Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Guatemala, Jamaica, Mexico, Paraguay, Peru, and Uruguay.

The nominal policy rate gap between Latin America and the Caribbean and the United States has narrowed to levels similar to those observed before the pandemic. During that period, the inflation rate of the U.S. economy was lower than its inflation target. Today, U.S. inflation is above the Federal Reserve target, so inflation rates in the region are closer to U.S. levels. Because of these smaller gaps, ex ante real interest rates in the region are, relative to the United States, more contractionary than before. Figure 5.4 shows that most Latin American and Caribbean economies with comparable policy rates now have higher ex ante real rates (measured as the policy rate minus current inflation) than in 2019. In this context, given the successful disinflation in some regional economies, even compared with developed economies, these countries can now align their nominal policy rates with their targets. Returning to a neutral rate will not only help in terms of not constraining output but will provide enough policy flexibility in the event that global uncertainty materializes into a lower aggregate demand or supply shock.

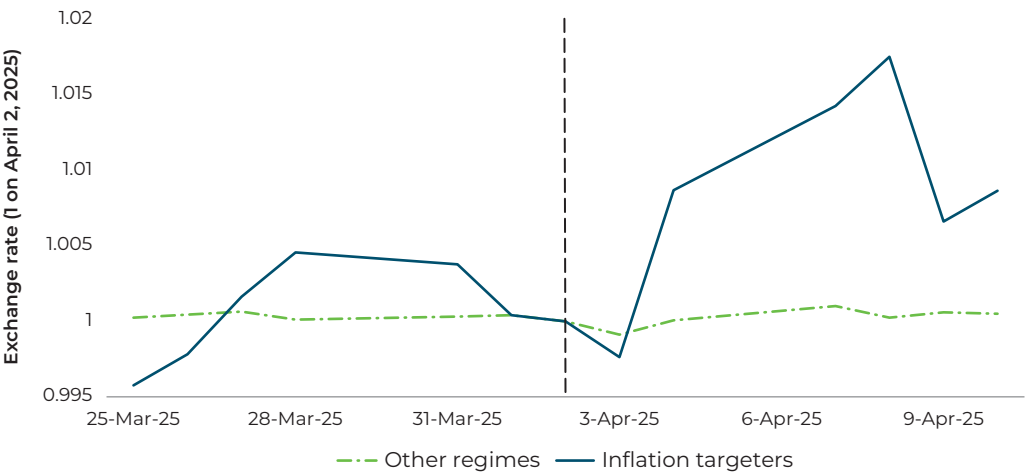
During periods of elevated global uncertainty, flexible monetary policy (and exchange rates) can serve as an effective buffer against negative shocks, such as rising trade costs (Jeanne and Son 2024; Candia and Pedemonte 2025). Maintaining price stability and a certain flexibility, when possible, in exchange rates is a powerful tool for macroeconomic adjustment (Egorov and Mukhin 2025). Recent external shocks illustrate the value of these policies. Following the United States' tariff announcements on April 2, 2025 ("Liberation Day"), nominal exchange rates in countries with flexible regimes depreciated rapidly, helping to absorb part of the external shock, as shown in Figure 5.5. In sum, although other factors have influenced exchange rate dynamics in the region, preserving flexible tools remains crucial in turbulent times.

FIGURE 5.4 ● Ex Ante Real Rates



Source: IDB staff calculations, based on data from central banks and Haver Analytics.
Note: Each dot represents a country's ex ante real rate relative to the United States in 2019 (x-axis) and 2025 (y-axis). The relative ex ante real rate is calculated using the policy rate for each country and subtracting the inflation of the period. After the real rate for each country is obtained, the ex ante real rate for the United States is subtracted.

FIGURE 5.5 ● Flexible Exchange Rates and Global Shocks



Source: IDB staff calculations, based on data from central banks and Haver Analytics.
Note: The figure shows the daily average normalized nominal exchange rate for inflation targeters (solid line) and countries with other regimes (dashed line), as defined in Figure 5.1. The index is equal to 1 on April 2, 2025.

Many economies remain reluctant to allow currency depreciation, fearing it may trigger higher inflation. Evidence suggests, however, that exchange rate pass-through in flexible regimes is typically modest and manageable when inflation is stable (Ha, Stocker, and Yilmazkuday 2019). By contrast, economies with alternative monetary policy regimes

experience higher inflation and greater concern about more substantial pass-through, with endogenous factors perhaps reinforcing the perception that pass-through is higher. Although exchange rate flexibility carries the risk of creating additional uncertainty when it is too volatile, both theoretical and empirical analyses suggest that greater flexibility can enhance resilience to adverse global shocks. A stable environment must accompany flexible tools to avoid negatively affecting economic agents' expectations.

Expectations of Economic Agents

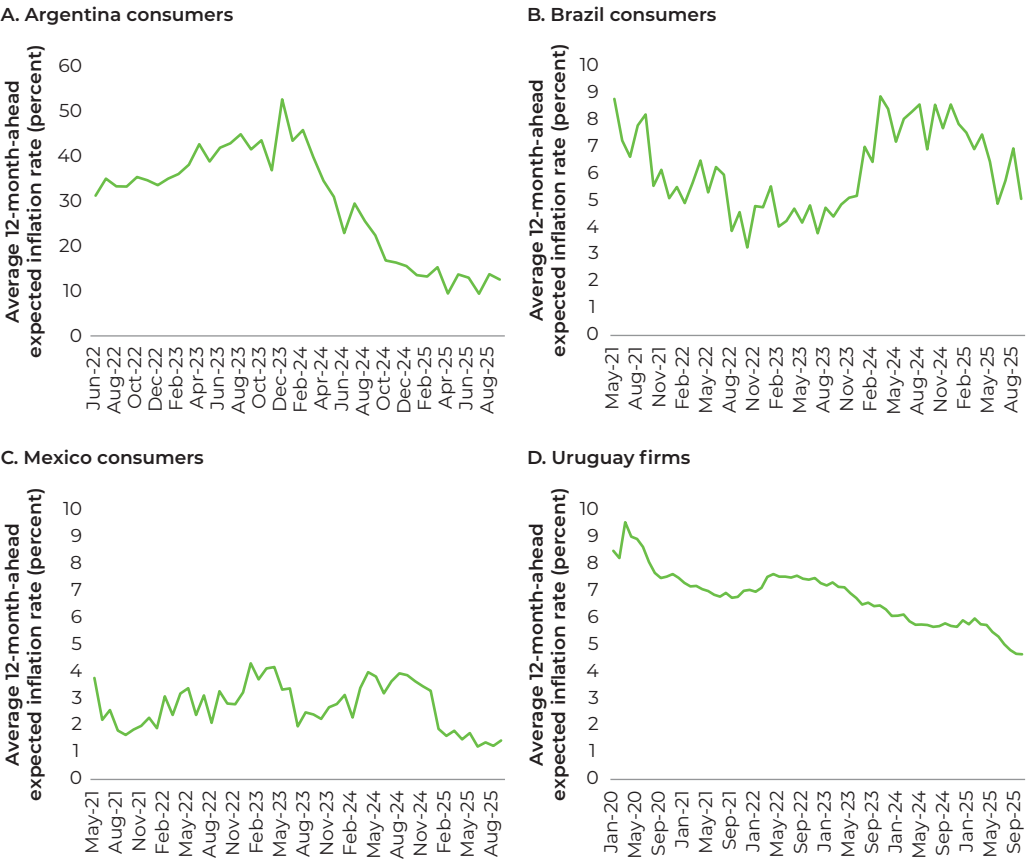
The rapid reaction of monetary authorities and successful disinflation also achieved a reduction in inflation expectations. To make sure the expectations fully return to levels consistent with the countries' targets, however, it is important they be monitored. Anchored inflation expectations are essential for the effective functioning of a flexible monetary policy regime, and the recent period of elevated inflation affected the expectations of both consumers and firms. While the disinflation was rapid, economic agents can extrapolate from those periods and maintain their expectations of higher inflation for a longer period. Malmendier and Nagel (2016) discuss this issue and show that periods of high inflation influence consumers' expectations for a long time. Pedemonte, Toma, and Verdugo (2025) show that these persistently higher expectations can have significant macroeconomic implications, posing challenges for monetary authorities and increasing inflation. As firms and consumers remember the high-inflation episode and extrapolate that history into the future, they influence current demand and prices, resulting in slower disinflation. This feature of macroeconomic expectations underscores the importance of swift, decisive monetary policy actions, like those taken by several Latin American and Caribbean monetary authorities.

For these reasons, it is also relevant to monitor the inflation expectations of consumers and firms. This is difficult, as relevant data remain scarce globally. The analysis presented here includes information drawn from two sources. On consumer expectations, Hajdini et al. (2024) provide survey data for a subset of countries, comprising Argentina, Brazil, and Mexico. On firm expectations, the data come from surveys conducted by the Central Bank of Uruguay. Figure 5.6 shows the time series.

Across the four countries, inflation expectations declined during 2024 and 2025. In some cases, such as that of Mexican consumers, expectations remained stable, but in others, like Argentinean consumers and Uruguayan firms, they declined significantly. Overall, these surveys reveal a successful reduction in inflation expectations for the available sample of countries and economic agents. The disinflation period not only lowered inflation levels; it convinced agents that prices were not going to grow persistently.

Additionally, lower and stable inflation can boost trust in central banks and other economic authorities; this can support policy actions, especially in periods of high

FIGURE 5.6 ● Inflation Expectations



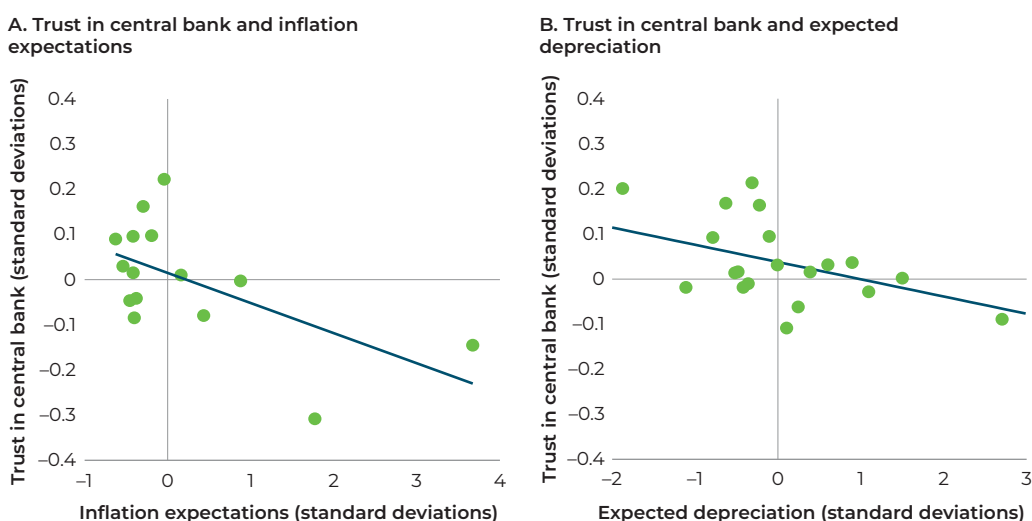
Source: The data for consumers in Argentina, Brazil, and Mexico are from Morning Consult, as described by Hajdini et al. (2024). The data for Uruguayan firms are from the Central Bank of Uruguay.
Note: Each graph shows average inflation expectations across consumers.

uncertainty (Ehrmann 2025). To evaluate how macroeconomic expectations and trust in the central bank interact in the region, a survey was conducted in the six largest economies in November 2025 to analyze how trust in monetary policy is related to expectations about the economy. One thousand consumers responded in each country about their inflation expectations, their expectations for the exchange rate, and how much they trust their country’s monetary authority to control inflation.² The survey revealed that inflation expectations and expected depreciation are related to trust in the central bank.

² Individuals are required to answer questions indicating a twelve-month-ahead expected inflation rate and a one-week-ahead and twelve-month-ahead expected exchange rate, and to indicate how much they trust the central bank using five response categories. With the one-week-ahead and twelve-months-ahead exchange rate expectations, an expected depreciation is estimated, as in Delgado et al (2024).

Figure 5.7 shows the correlation between inflation expectations and exchange rate expectations with trust in the monetary authorities of each country.³ There is a significant negative relationship: Within a country, individuals whose inflation expectations are higher than the country's average mistrust their central bank more. Individuals who expect the value of their currency to decrease the most relative to the U.S. dollar also trust their monetary authorities less. These results highlight how trusting the central bank and expecting a stable value of the local currency go hand in hand.⁴ Monetary authorities can anchor these expectations by, for example, promoting credible rules and improving communication with the general public (Blinder 2024; Coibion et al. 2020).

FIGURE 5.7 • Trust in Central Bank and Expectations about the Macroeconomy



Source: Survey of Consumers' Expectations, IDB.

Note: Trust in the central bank is measured by asking consumers how much they trust the ability of the central bank to control inflation. Consumers can answer whether they are very satisfied; satisfied; neither satisfied nor unsatisfied; unsatisfied; or very unsatisfied. The answers are ordered from 1 (very unsatisfied) to 5 (very satisfied). An average and standard deviation are obtained by country and each answer normalized by subtracting the country's average and dividing by its standard deviation. Inflation expectations are measured by asking consumers by what percentage they think prices in the economy will increase (inflation) or decrease (deflation) in the next twelve months. Expected depreciation is measured by first asking what consumers think the value of the U.S. dollar will be by the end of the month and then the expected value for the next twelve months. Percentage changes between one month and twelve months are measured, and this measure is then normalized using the same method as for inflation expectations. Five percent of the highest and lowest answers for inflation expectations and expected depreciation are removed.

³ To make the figure comparable across countries, each variable is normalized, subtracting the country's mean and dividing by its standard deviation.

⁴ A causal negative effect of expected depreciation on trust in the central bank is estimated using exogenous variation induced at the individual level to influence expected depreciation.

New Digital Assets in Foreign Currencies

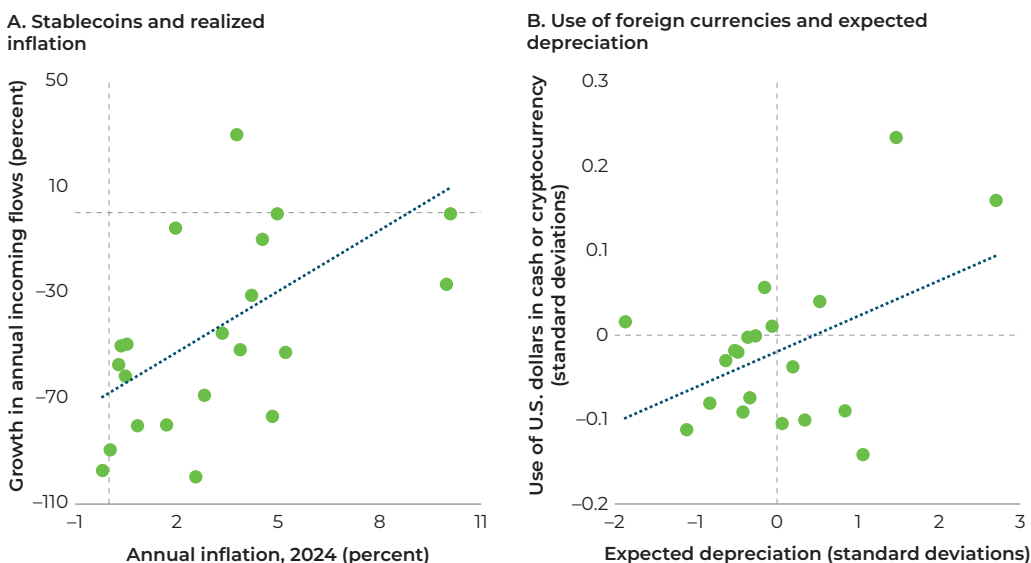
Many of the emerging alternatives with respect to digital assets are indexed in foreign currency, which, in many economies, facilitates dollarization. High dollarization and mistrust in local economic institutions can undermine the effectiveness of monetary policy. In periods of higher inflation or greater instability, consumers may protect the value of their assets in real terms by shifting them into instruments indexed to foreign currencies. New technologies that allow them to use digital assets, such as stablecoins, can help them dollarize their assets and transactions.

The consumer survey developed for this analysis asked respondents whether they use financial instruments, such as cash holdings in U.S. dollars or cryptocurrencies, to hold their assets. Of the sample, 12 percent said they use cryptocurrencies, while only 10 percent reported holding dollars in cash. This finding held a generational component: Respondents aged 65 or over held 6 percent less of their assets in cryptocurrencies than those aged 18 to 34. The finding indicates that the use of stablecoins may be more prevalent than traditional U.S. dollar cash holdings.

According to the Cambridge Digital Money Dashboard from the Cambridge Center for Alternative Finance, stablecoin flows in Latin America and the Caribbean nearly doubled between 2022 and 2024. This increase coincided with the broader adoption of digital payment systems, as documented in the Latin American and Caribbean Microeconomic Report (Vera-Cossio 2025). In fact, in the survey conducted for this analysis, 34 percent of respondents said they had a digital payment account, and 15 percent said they would have their next paycheck deposited into one.

Digital technologies may be used out of convenience—for example, for cross-border payments—or for hedging purposes. They can facilitate the adoption of foreign currencies, and because stablecoins are typically denominated in U.S. dollars, their growing use poses risks to monetary sovereignty. Because monetary policy in small open economies operates through changes in the exchange rate, the indexing of assets to a foreign currency by a large proportion of the population can make traditional monetary policy tools less effective.

The economic environment influences the use of foreign currency-denominated instruments. The data indicate that, in countries where inflation is high, stablecoin flows increase proportionally (Figure 5.8, Panel A). Additionally, individuals who expected a higher depreciation of the local currency—meaning the value of the local currency relative to the U.S. dollar will be lower—tend to use more cryptocurrencies or U.S. dollars in cash (Figure 5.8, Panel B). These findings show that higher inflation rates can affect the use of currencies.

FIGURE 5.8 • Stablecoins and Inflation

Source: Panel A: IDB staff calculations, based on the publicly available data on the “Geography of Stablecoin Flows” from the Cambridge Digital Money Dashboard, which are in turn based on Chainalysis data. Panel B: Survey of Consumers’ Expectations, IDB.

Note: Panel A plots the cross-country relationship between annual Consumer Price Index (CPI) inflation in 2024 and the growth rate of incoming stablecoin flows in 2023. For each country, the year-on-year percentage change was computed in these incoming flows for the period September 2022 to September 2023. In Panel B, consumers were asked whether they held money in one of six financial instruments: bank account, cash in local currency, cash in U.S. dollars, cryptocurrency, digital payment account, or other. Consumers could respond to multiple options. This answer was normalized using country average and standard deviations, as explained in Figure 5.7. The same procedure as in Figure 5.7 was also used for the expected depreciation.

As discussed in Azevedo et al. (2025), digital payments have grown into a convenient and secure method of transaction. Depending on the platform, however, these innovations may introduce risks to financial stability. New financial intermediaries can circumvent regulation through digital channels, while stablecoins themselves are subject to risk and potential loss of value, which could harm consumers directly (Ahmed et al. 2025). The convenience of digital payments could backfire if they are used through less regulated channels or with financial instruments that expose consumers to risk. In that sense, promoting safe and stable digital instruments can help with avoiding exposure to unregulated financial instruments or ones that can reduce the effectiveness of traditional monetary policy tools, as monetary policy remains an effective tool for output and price stability.

Central banks in the region have tools to respond proactively to these developments by reinforcing the stability of their currencies to reduce the incentive to use instruments denominated in other currencies. As Cipollone (2024) discusses, the convenience of digital alternatives to cash, both for retail and consumer use, also risks the loss of domestic

currency users. Central banks can protect the use of the domestic currency by exploring the use of alternative digital technologies to meet the demand. Many central banks worldwide have explored the development of Central Bank Digital Currencies (CBDCs), which are digital versions of central bank-issued physical cash. Countries in the region, such as the Bahamas, have developed such currencies, but big, developed economies, such as the Eurozone, are also considering their use. CBDCs can be stored in digital wallets and used for transactions much like physical cash, allowing central banks to adapt to the growing demand for digital payments. The adoption of this new technology has not yet been well studied, and several operational and practical challenges are associated with it.

One concern regarding CBDCs is that their widespread adoption could reduce reliance on bank deposits, as their substitution for them can reduce the need to hold currencies in private banks. Georgarakos et al. (2025) find that, in the euro area, consumers are willing to adopt digital currencies but would transfer only a limited portion of their wealth to them. This suggests that creating a digital alternative to cash might not fully replace bank deposits, thereby limiting its impact on the banking system.

But even with small changes in deposits, the benefits of developing CBDCs can be elusive because of the deposits' cost. Paul, Ulate, and Wu (2024) evaluate the macroeconomic implications of CBDC adoption for welfare and conclude that, while such instruments could increase competition in the banking sector and reduce profits, their implementation could yield welfare gains. Nevertheless, important risks remain related to cybersecurity and financial stability. Hence, the implementation and diffusion of CBDC technologies needs careful assessment.

The risks of adopting new technologies can be significant but remain unclear. At the same time, many benefits are associated with their increased adoption. Ensuring a stable macroeconomic environment, then, in which consumers can hold their assets in local currencies without risking significant losses from macroeconomic instability, remains the main policy tool and prescription.

Monetary Policy Challenges Moving Forward

This chapter discussed some of the many challenges monetary authorities in Latin America and the Caribbean will face in the coming years. One message is positive: After years of large international shocks and high volatility, many economies have managed to close their output and inflation gaps. The challenge moving forward will be to adjust the policy stance to allow economies to grow and be prepared for future contingencies. Reaching a neutral stance will enable these economies to develop flexible tools that will help them absorb negative external shocks.

But large shocks like the ones experienced in the past five years can leave consumers scarred. This chapter showed that, while expectations have returned to low levels on average, important sources of heterogeneity exist in some economies. Within countries, those individuals who maintain higher expectations of inflation or local currency depreciation tend to mistrust local monetary authorities. Clear rules and improved communication by central banks with the general public—not only financial markets—can support the creation of a stable environment to consolidate the anchoring of expectations and promote trust in monetary policy institutions.

Also discussed was how higher expectations affect the portfolio allocation of consumers. The survey developed for this chapter shows that individuals with higher expected depreciation tend to prefer assets in foreign currencies. Higher levels of dollarization can be prevented if monetary authorities ensure a stable monetary environment, anchor expectations, promote trust in economic institutions, and monitor the development of digital financial instruments to ensure alternatives in local currency.

CHAPTER 6

Behind External Accounts

In a reversal of the narrowing observed in 2023–24, current account balances in Latin America and the Caribbean slipped back into deficits in 2025. Financing pressures have again come into focus as tighter global conditions raise net interest payments. While most countries in the region have maintained access to international markets, external borrowing has become more expensive, and some economies have addressed their external gaps through a mixture of modest reserve drawdowns and official lending. Remittances—an important source of external income for many Latin American and Caribbean economies—have also been affected by increased uncertainty amid policy discussions in North America.

Developments that contributed to an improvement in trade balances for Latin America and the Caribbean in 2025 included the smaller increases in effective tariffs on exports to the United States than were imposed elsewhere. This allowed some of the region's countries—most notably Mexico—to expand exports. This response was concentrated, however, in a limited set of products and markets and cannot be attributed to sustained growth in export volumes or market share. Still, beneath these short-run dynamics, emerging investment in high-tech manufacturing and critical minerals hints at deeper structural diversification that could strengthen the region's export potential over the longer term, as discussed in Chapter 2.

Against this backdrop, this chapter argues that tighter financing constraints and persistent structural barriers to export expansion leave the region vulnerable at a time when global technologies and geopolitical relationships are evolving rapidly. These dynamics heighten exposure to the risk-off episodes discussed in Chapter 3 and underscore the need to rebuild policy buffers and strengthen macroprudential and fiscal frameworks. Continued efforts to deepen regional integration—through expanded intraregional trade, greater foreign direct investment (FDI), and stronger regional value chains—will be essential to support more durable external resilience.

Current Account: A Closer Look at Recent Developments

Starting in mid-2022, following the sharp current account deficits triggered by the pandemic, Latin America and the Caribbean experienced a partial rebound. By 2024, however, the improvement had faded, and by early 2025, most countries had slipped back into deficit. The GDP-weighted current account balance moved from –0.5 percent in late 2023 to –2.5 percent in the first quarter of 2025, before showing a modest recovery in mid-2025 (Figure 6.1, Panel A). The median balance followed a similar path, falling from +0.5 to –0.1 percent of GDP but with wide and persistent dispersion across countries, as some continued posting surpluses while others remained in deep deficit.

Trade is no longer the main source of external pressure. Since the third quarter of 2024, the region’s trade balance has gradually improved, reaching a marginal surplus by mid-2025. This marks a turnaround from the deficits seen in 2022, when shortfalls reached nearly 2 percent of GDP. The composition of trade has remained relatively stable, with positive goods balances consistently offset by deficits in services. But the recent deterioration in the current account is no longer driven by trade. As shown in Figure 6.1, Panel B, the widening gap comes from the income account, with primary income outflows having deepened, largely as a reflection of higher debt service payments resulting from the tighter global financing conditions. Secondary income inflows—driven by remittances—have remained large but broadly flat at the regional level, reflecting offsetting cross-country dynamics, even as remittance inflows to Mexico have decelerated sharply from February (see Box 6.1).

FIGURE 6.1 • Current Account Balance in Latin America and the Caribbean

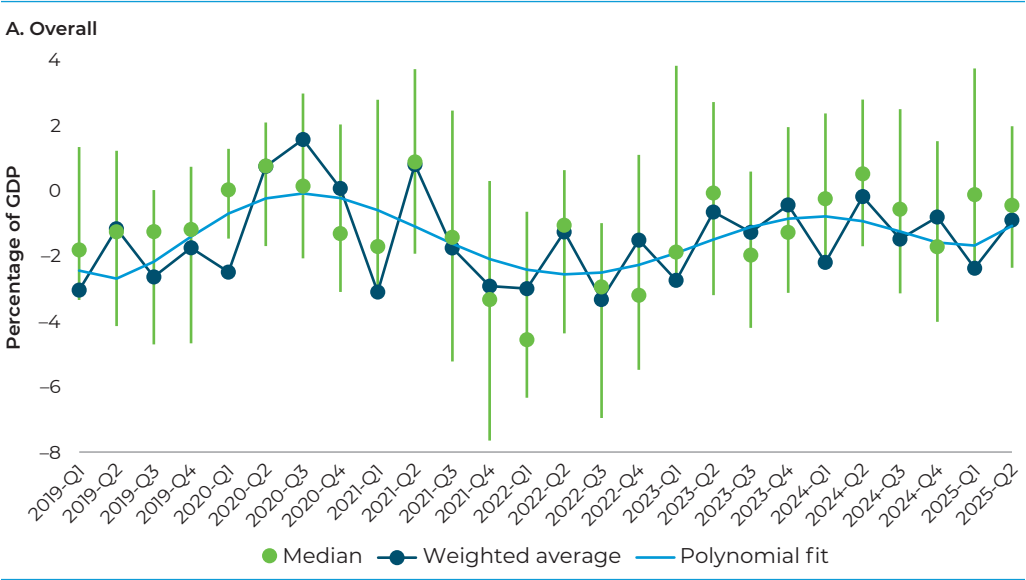
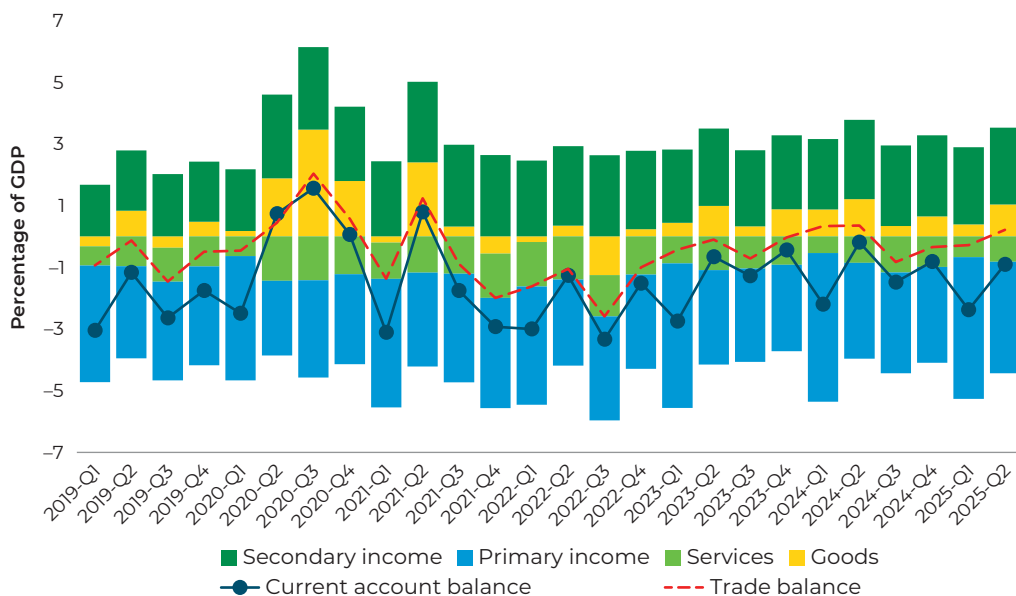


FIGURE 6.1 ● **Current Account Balance in Latin America and the Caribbean** *(continued)***B. By components**

Source: IDB staff calculations, based on IMF International Financial Statistics.

Note: The figure presents quarterly current account balances in Latin America and the Caribbean. Panel A shows the interquartile range across countries (the vertical lines), the GDP-weighted regional average (the jagged line), and a polynomial smoothing of that series (the curvy line). Panel B decomposes the weighted average into primary income, secondary income, and the trade balance (dashed line), with the last further split into goods and services.

BOX 6.1 ● **Remittances: A Buffer That's Holding, But Shifting**

Remittances remain one of Latin America and the Caribbean's most important external buffers. For many economies in the region, they are not only a source of household income but a macroeconomic stabilizer that supports consumption, helps finance trade deficits, and sustains external liquidity in periods of stress. In parts of Central America, remittances represent 20 to 30 percent of GDP, and in Caribbean economies such as Haiti and Jamaica they exceed 10 percent. Recent trends, however, suggest this buffer—while still holding—is beginning to shift in composition, intensity, and geography.

While overall levels remain high, recent remittance dynamics have become increasingly uneven. Throughout 2023 and into 2024, real remittances to Central America accelerated sharply, with growth exceeding 25 percent in some quarters. In contrast, Mexico saw a marked slowdown, including periods of flat or slightly negative year-on-year growth. The divergence between Mexico and Central America is of special interest, as it marked a break from the more synchronized behavior seen earlier in the decade, when flows to both places tended to move in parallel with U.S. labor market conditions (Harris, Maldonado, and Cortés Sánchez 2025).

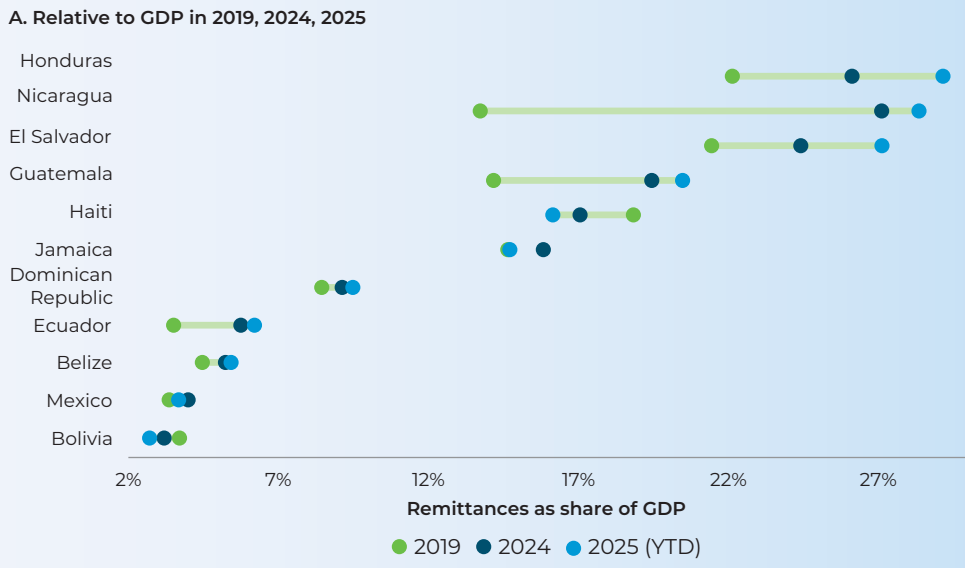
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BOX 6.1 • Remittances: A Buffer That’s Holding, But Shifting *(continued)*

Part of the divergence reflects differences in how remittance inflows have evolved along two margins: the intensive margin—average remittances per labor force participant—and the extensive margin—the number of migrants participating in the U.S. labor force. In Mexico, most of the variation is driven by the extensive margin, shown by the dashed line in Panel B of Figure B6.1.1, as the migrant labor force has leveled off (Figure B6.1.1, Panel C). In Central America, by contrast, the increase is primarily explained by the intensive margin, as migrants already in the labor force have increased transfers.

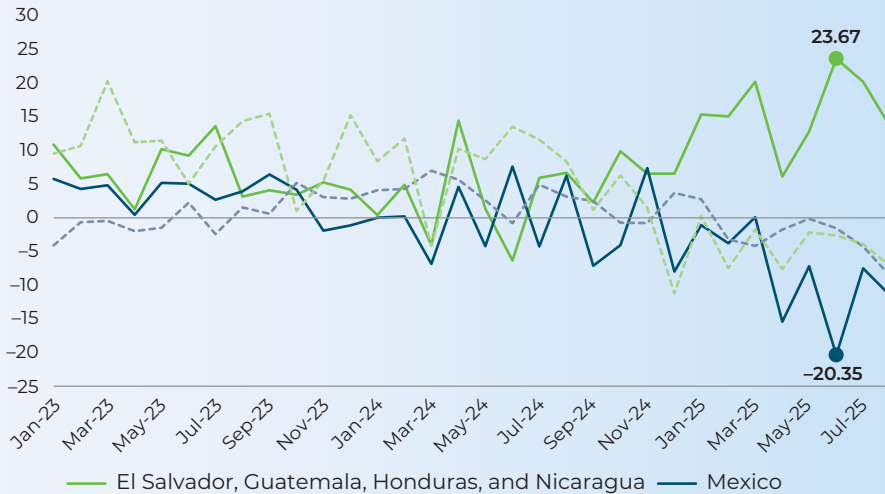
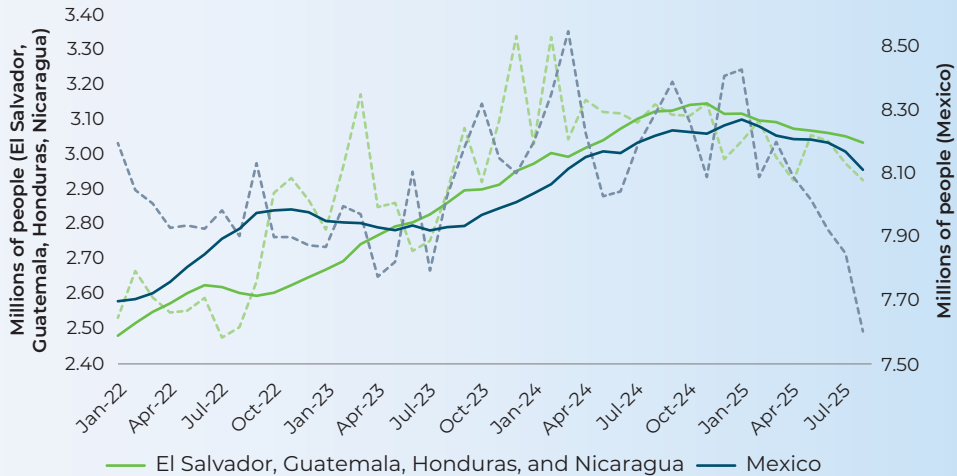
Understanding these shifts requires a closer look at recent drivers. In Central America, part of the surge appears precautionary; migrants may be advancing transfers ahead of a proposed 1 percent remittance tax scheduled for 2026, supported by increased work hours and modest labor market gains. In Mexico, by contrast, slower growth in remittances reflects changes in migration patterns, labor force participation in the United States, and exchange rate conditions. Recent work by IDB (2026) highlights an additional channel. Rising uncertainty in migration policy—captured through a newly constructed index based on media coverage—has had a measurable impact on remittances to Mexico, reducing year-on-year growth by up to 12 percentage points during periods of high uncertainty. This effect is not observed in Central America, where remittances are more closely tied to subsistence motives and appear less sensitive to shifts in the policy environment.

FIGURE B6.1.1 • Remittances in Latin America and the Caribbean



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BOX 6.1 • Remittances: A Buffer That's Holding, But Shifting *(continued)***FIGURE B6.1.1 • Remittances in Latin America and the Caribbean** *(continued)***B. Year-over-year percentage change****C. Labor force of U.S. residents born in Mexico and selected Central American countries**

Source: IDB staff calculations, based on national statistical offices, central banks, and IPUMS CPS microdata, using person weight.

Note: Panel A shows the share of remittances to GDP for the 11 economies with the highest ratios. Panel B shows year-over-year percentage changes in real remittances, deflated using the U.S. Consumer Price Index (CPI; January 2019 = 100), comparing Mexico with El Salvador, Guatemala, Honduras, and Nicaragua. Dashed lines correspond to the number of migrants in the labor force, the extensive margin. Panel C reports the monthly level of the CPS-weighted labor force of U.S. residents born in Mexico or in one of four Central American countries. Dashed lines show monthly values; solid lines show 12-month moving averages.

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BOX 6.1 • Remittances: A Buffer That's Holding, But Shifting *(continued)*

Differences in how remittances are used also help explain this divergence. In Mexico, a larger share is directed toward investment-related spending, such as housing and discretionary projects, which tend to respond more to perceived risk. In Central America, remittances are more commonly used for basic consumption, making them less responsive to cyclical or political shocks (IDB 2026). In South America, this dynamic is most visible through Venezuela, where large-scale outward migration has generated remittance inflows across the region, making remittance-related transfers an increasingly important stabilizing component of the current account since 2018.

Beyond their impact on GDP and external balances, remittances also influence labor market outcomes in high-recipient countries. In economies where remittances represent a large share of household income—including Central America and the Caribbean—these inflows are associated with lower labor market participation at the margin. At the same time, evidence across Latin America and the Caribbean shows that remittances play a clear positive role in reducing poverty and inequality and in stabilizing household consumption, highlighting a relevant policy tradeoff for high-remittance economies. Crucially, the role of remittances is evolving. Remittances remain an important stabilizer, but the drivers behind them are changing, and their role will differ across countries as labor dynamics, enforcement policies, and exchange rate movements continue to evolve.

What Happened to Global Trade in 2025

Shifts in global trade policy reshaped trade conditions in 2025, with uneven effects across regions. While the overall direction marked a move toward greater restriction, the incidence varied substantially across partners and sectors. Latin America and the Caribbean was less affected than Asia or Europe, benefiting in some cases from temporary improvements in relative access to the U.S. market. These advantages, however, proved sensitive to subsequent policy realignments, and, in the case of Mexico, the initial edge narrowed as new bilateral agreements and trade rerouting altered relative tariff conditions.

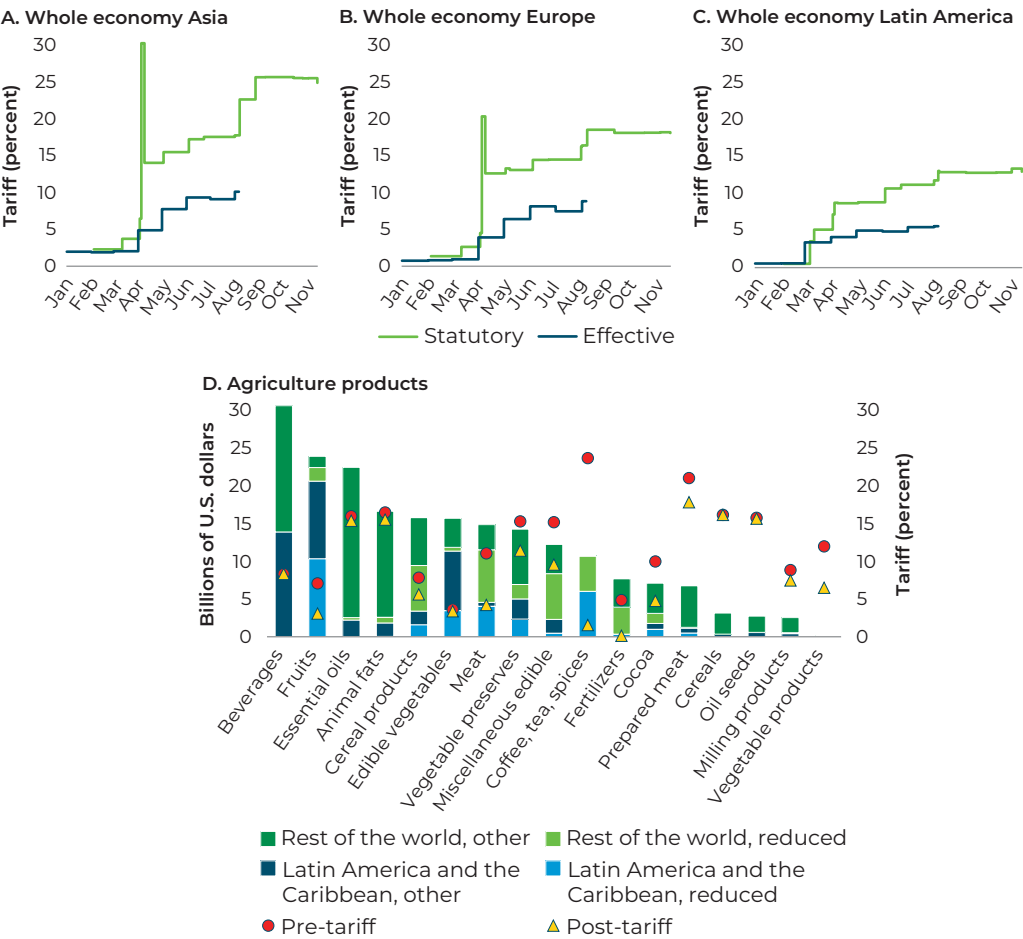
The turning point came on April 2, when the United States announced a broad reciprocal tariff initiative affecting all trading partners. Pressures, however, had already been building. Early in 2025, the United States tightened its stance under Section 232 of the Trade Expansion Act of 1962, aligning steel and aluminum tariffs at 25 percent and extending coverage to automobiles and auto parts. Remaining country exemptions were removed, bringing Canada and Mexico fully under Section 232. For automobiles, tariffs were applied to Canadian and Mexican vehicles, with an exception only for U.S. content. At the same time, the United States imposed a new 20 percent across-the-board tariff on imports from China.

The far-reaching package unveiled by the Trump administration imposed tariffs with rates starting at 10 percent. Canada and Mexico retained preferential access for goods in compliance with the 2020 United States-Mexico-Canada Agreement (USMCA), while Latin America and the Caribbean incurred only the minimum increase, making it the least affected region. Notably, the Caribbean was largely insulated from the direct effects of recent U.S. tariff increases, reflecting an export structure concentrated in tourism services, oil and gas, and gold—sectors mostly exempt from tariff measures. As a result, less than 5 percent of Caribbean exports to the U.S. were directly affected. Looking ahead, risks are primarily indirect, operating through higher import costs and weaker U.S. demand affecting tourism and investment (Mercer-Blackman et al. 2025). China, by contrast, was subject to one of the steepest hikes, at 34 percent. The package also carved out strategic sectors—pharmaceuticals, energy, petroleum, minerals, and semiconductors—which together account for roughly one-fifth of U.S. imports; this shaped the policy's effective reach.

Tensions eased somewhat in the weeks that followed, as China and the United States suspended part of the additional hikes and reopened negotiations. Over the summer, the United States reached bilateral agreements with the European Union, Japan, the Republic of Korea, and the United Kingdom, establishing a new tariff floor. At this writing, most imports from the EU, Japan, and Korea face a 15 percent baseline, which is lower than initially proposed but still above pre-2025 levels. The UK secured a distinct arrangement: a general 10 percent rate and zero tariffs on pharmaceutical exports, the only full exemption granted.

Panels A, B, and C of Figure 6.2 summarize the cumulative effect of these changes, comparing statutory and effective U.S. tariff levels across regions. In April, as reciprocal measures took effect, statutory rates spiked, while effective tariffs rose more gradually, reflecting exemptions, rollbacks, and export composition. The effective rate is calculated based on actual duties paid relative to import values, using U.S. Census Bureau data. As such, it reflects not just the headline tariffs but also how products enter the U.S. market—whether under Most Favored Nation (MFN) status or via preferential agreements like USMCA. The figure shows the relative position of Latin America and the Caribbean. Although the region was affected, overall incidence remained lower than elsewhere. This pattern is illustrated by Mexico: Despite losing its Section 232 exemption—meaning automobiles were now subject to a 25 percent tariff on all non-U.S. content, even when USMCA-compliant—it initially retained a preferential position relative to other exporters (Alfaro and Chor 2025). That effective advantage improved later in the year, as more Mexican exporters began using USMCA provisions in response to wider tariff differentials, although the relative gap narrowed as reduced tariff floors were extended to the EU, Japan, Korea, and the UK.

FIGURE 6.2 • Statutory and Effective Tariff



Source: IDB staff calculations, based on U.S. Census customs data, the World Integrated Trade Solution (WITS), and the IDB tariff tracker based on the U.S. International Trade Commission.

Note: The figure shows the evolution and sectoral breakdown of statutory and effective U.S. tariffs in 2025. Panels A, B, and C present average tariff levels by region (Asia, Europe, and Latin America and the Caribbean), distinguishing between statutory rates and effective applied tariffs, which reflect reductions resulting from partial rollbacks. Panel D shows tariff exposure and reductions for key agricultural products, measured in terms of 2025 (February–August) export value (bars, left axis) and effective tariff levels before and after the policy shift (dots and triangles, right axis). Latin American and Caribbean and rest-of-world exporters are shown separately.

BOX 6.2 • A Closer Look at the Mexican Auto Industry

In 2025, Mexico's position in the U.S. automobile market shifted notably. Mexico's auto industry preserved a relative advantage in the U.S. market following the 2025 tariff changes, but its absolute exposure increased, and competition from Japan and Korea intensified under new trade arrangements. Under Section 232 rules current at this writing, only U.S.-origin content is exempt from the 25 percent tariff, so even USMCA-compliant vehicles assembled entirely with Canadian or Mexican parts are taxed at the full rate. Despite this,

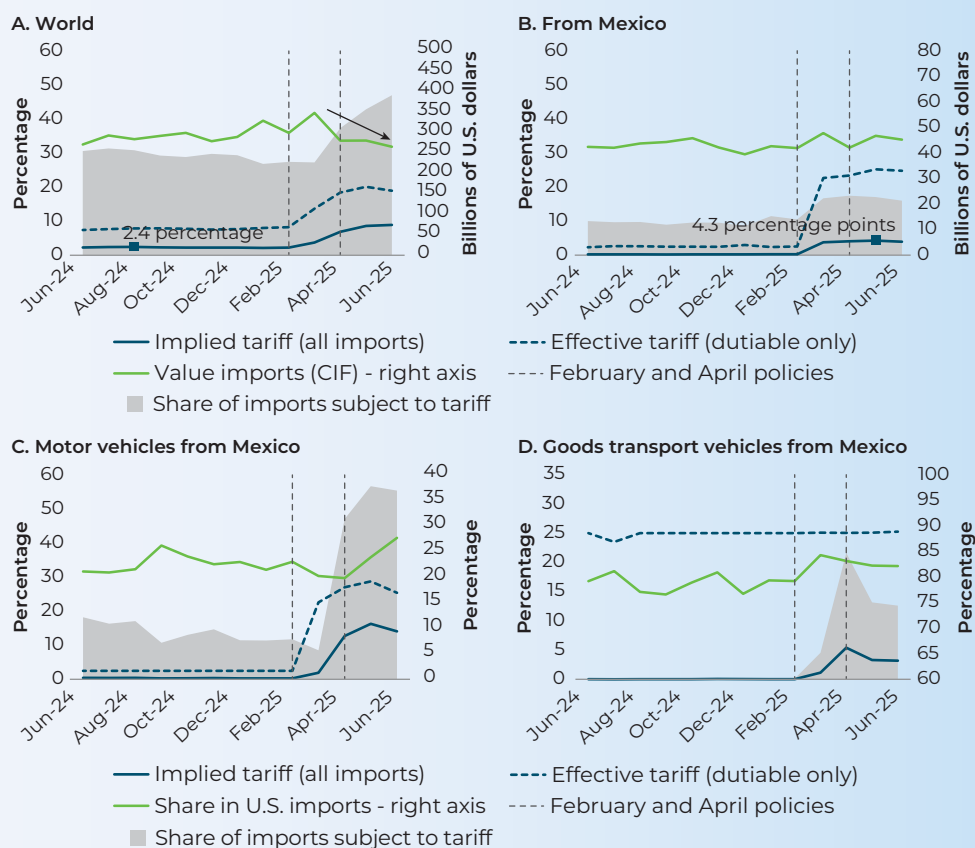
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BOX 6.2 • A Closer Look at the Mexican Auto Industry *(continued)*

Mexico initially retained an advantage over other exporters, thanks to deep integration and preferential access. But recent U.S. trade agreements with Japan and Korea have begun to erode that lead, intensifying competition in a key export sector. At the same time, Mexico remains exposed to nontrade policy risks which continue to shape the bilateral agenda and add uncertainty for investors.

Figure B6.2.1 illustrates these dynamics. While total U.S. imports declined slightly after April 2, Mexican exports remained broadly stable, showing the resilience of Mexico's position. Although the share of U.S. imports subject to tariffs rose sharply, from about 30 percent to over 45 percent globally, Mexico saw only a modest increase, from 10 to 15 percent.

This shift also widened the relative gap in implied tariff rates. Before April, Mexican auto exports entered the United States duty free, while imports from other countries incurred the

FIGURE B6.2.1 • U.S. Imports

Source: IDB staff calculations, based on IMF International Financial Statistics.

Note: The share of imports subject to tariff is calculated as dutiable imports divided by total imports; the implied tariff is duties paid divided by total imports; and the effective tariff is duties paid divided by dutiable imports. The right axes of Panels C and D show the share of U.S. imports for the respective import products under the U.S. Harmonized Tariff Schedule: HS 8703 (motor vehicles for the transport of persons) and HS 8704 (motor vehicles for the transport of goods).

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BOX 6.2 • A Closer Look at the Mexican Auto Industry *(continued)*

most favored nation (MFN) rate of around 2.5 percent. By mid-2025, Mexico's implied tariff rose to 5 percent, following the loss of its Section 232 exemption. At the same time, however, the global average jumped to over 10 percent. As a result, although Mexico is now subject to a higher tariff than before, its relative advantage over other exporters has increased. Panels C and D further illustrate how this pattern varies across product types, with passenger vehicles showing a larger increase in tariff exposure than trucks following the expiration of Mexico's Section 232 exemption.

Another wave of exceptions followed in November 2025, when the United States rolled back reciprocal tariffs on a targeted set of agricultural products. An executive order issued in September identified more than 2,000 eligible items, and by mid-November tariffs had been lifted on 248 of them, mainly affecting Asian and Latin American and Caribbean exporters. The rollback applied only to duties introduced in April and August, leaving base rates unchanged. For most Latin American and Caribbean countries, this implied tariff reductions of around 10 percent, while some Asian products saw cuts of 20 to 40 percent. A separate executive order later in November removed a 40 percent tariff on selected Brazilian exports, resulting in cumulative reductions of up to 50 percent for certain products.

Some of the agricultural products affected by the November tariff rollbacks are shown in Panel B of Figure 6.2. The bars report export values earlier in the year (February–August), distinguishing products for which tariffs were reduced and separating Latin American and Caribbean exporters from the rest of the world, and the markers show effective tariff rates before and after the policy change. The figure indicates that the rollback applied to products with sizable export exposure, many of them supplied by Latin American and Caribbean exporters, and led to a clear decline in effective tariffs. For these products, lower tariffs could benefit exporters through two channels: by allowing a recovery of profit margins that may have been compressed to remain competitive under higher tariffs, and by restoring demand that may have been lost when tariffs raised prices.

In sum, the sequence of tariff adjustments, exemptions, and bilateral agreements has resulted in a changing trade policy environment. This evolution affects how firms form expectations and plan production and investment, with implications for trade flows beyond headline tariff levels.

The Impact of Recent Changes in Tariffs

Given these sources of uncertainty and the potential for heterogeneous impacts across sectors and partners, this section assesses three trade policy scenarios using the

quantitative multicountry, multisector general equilibrium model developed by Alvarez and Espinoza (2025).¹

Trade-related uncertainty is likely to persist. Recent events showed how changes in tariffs, exemptions, and retaliatory measures can affect trade flows and price signals. While countries in the region cannot influence these shifts, they can prepare for them by strengthening trade monitoring and scenario planning, maintaining flexibility in trade strategies, and advancing efforts to improve access to diverse export markets.

The first scenario captures the policy environment as of April 2, 2025, incorporating the 20 percent U.S. tariff on Chinese imports, full enforcement of the Section 232 tariffs on steel, aluminum, and autos, and reciprocal tariffs as announced; it assumes no retaliation. Under this setting, Canada and Mexico retain partial exemptions: Auto parts are excluded, and autos are taxed only on their non-U.S. content. The second scenario reflects the tariff landscape by December 2025, including bilateral deals signed since May and new exemptions, such as lower tariff floors for key partners and sectoral carve-outs in agriculture. The third scenario builds on the second by restoring USMCA treatment for Canada and Mexico under Section 232. Vehicles and auto parts that meet USMCA rules of origin enter duty free, while noncompliant goods are subject to the 25 percent Section 232 tariff rather than MFN rates, as was the case before March 2025.

Table 6.1 summarizes the simulated impact of each scenario on export performance across regions measured as the percentage change in total trade value. Under the April 2025 configuration (scenario 1), almost every country would have faced sharper export losses, reflecting the higher tariff structure in place at that point. The December 2025 scenario (scenario 2) shows smaller declines, particularly for countries with large agricultural exposure and significant U.S. market share—such as Brazil, Chile, and Peru. This finding is consistent with the implementation of new bilateral deals and tariff carve-outs. Mexico stands out as a clear exception. In scenario 2, its relative position worsens, with a 7 percent decline in export value, as agreements with Japan and Korea erode its competitive edge in autos. The third scenario restores differentiated treatment under Section 232 for Canada and Mexico: USMCA-compliant vehicles and parts enter duty free, while non-compliant goods come under the 25 percent tariff, rather than reverting to MFN rates. This shift substantially improves Mexico's export outcome—from a 7 percent decline in scenario 2 to a 2.4 percent gain in scenario 3—highlighting the role of preferential treatment and rules of origin in shaping bilateral trade flows.

¹ This analysis builds on the framework used in Ayres, Izquierdo, and Parrado (2025). In particular, the model is a quantitative multicountry, multisector general equilibrium trade framework building on Caliendo and Parro (2015), with explicit input–output linkages across sectors and countries. It is calibrated using updated bilateral trade and production data, sectoral input–output tables, detailed product-level tariff schedules, including exemptions and retaliatory measures, and granular sector-specific trade elasticities from recent estimates (Fontagné, Guimbard, and Orefice 2022). The framework allows tariff shocks to propagate both directly and indirectly through global value chains. Full documentation of the model structure, data construction, calibration, and scenarios is provided by Alvarez and Espinoza (2025).

TABLE 6.1 • Trade Impact of Tariff Scenarios

	Trade value (percent change)		
	Scenario 1: April 2	Scenario 2: Actual (December 2025)	Scenario 3: Differentiated Section 232 treatment for Canada and Mexico
Argentina	-1.58	-1.42	-1.43
Brazil	-3.87	-3.76	-3.55
Chile	-3.28	-2.46	-2.50
Colombia	-3.44	-2.76	-2.80
Costa Rica	-2.67	-3.15	-3.33
Mexico	-5.34	-7.03	2.41
Peru	-4.93	-3.67	-3.34
China	-6.66	-6.85	-6.93
Japan	-5.22	-4.44	-4.50
Korea	-6.20	-5.24	-5.41
Germany	-2.41	-2.25	-2.25
United Kingdom	-2.34	-1.87	-1.86

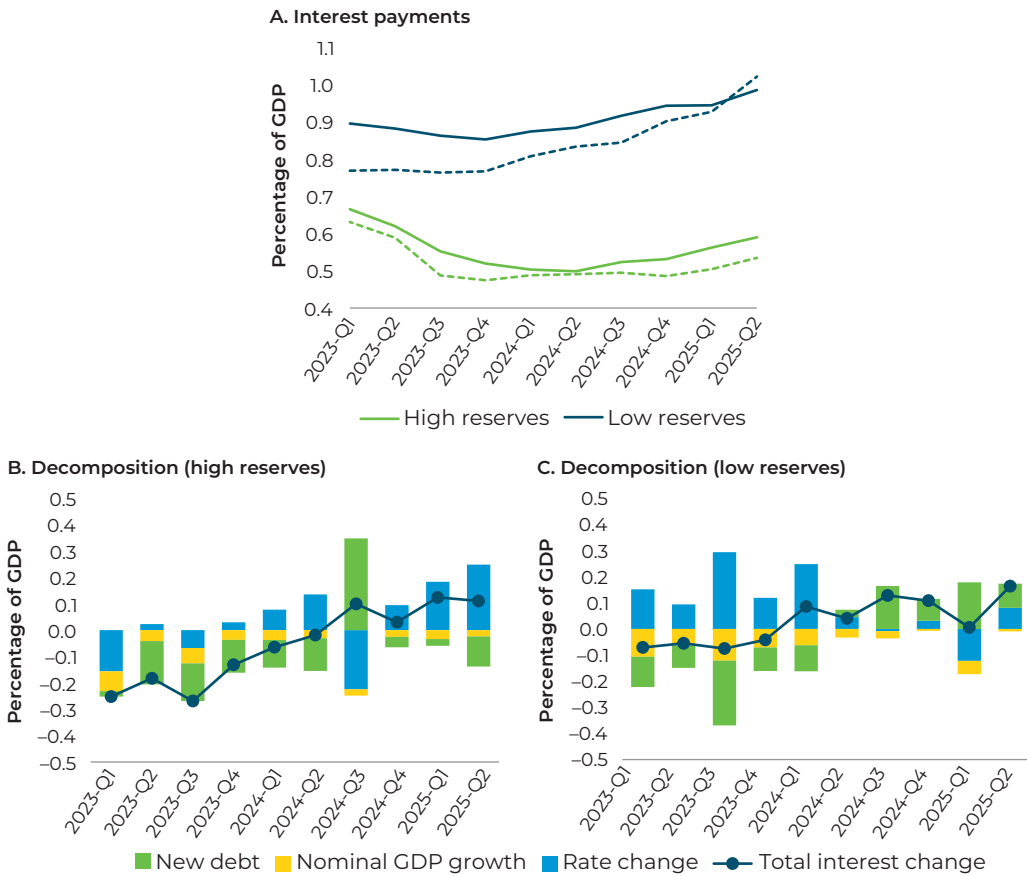
Source: IDB staff calculations, based on Alvarez and Espinoza (2025).

Interest Payments: Diverging Paths, Common Pressure

After several years in which interest payments remained relatively stable, the cost of external debt once again became a source of pressure, particularly for countries with weak buffers. As shown in Figure 6.3, the average external interest bill in low-reserve countries rose steadily, reaching close to 1.2 percent of GDP by early 2025. Countries with stronger reserve positions, by contrast, saw a slower and more stable increase. This divergence demonstrates how reserve accumulation—together with macroprudential policies that limit balance-sheet exposure to external shocks—helps contain external financing costs.²

Panels B and C of Figure 6.3 decompose into three components the year-to-year change in interest payments arising from debt securities reported in the international investment position: new debt issuance, changes in effective interest rates, and nominal GDP growth. This decomposition is analogous to that used in Chapter 4 for public debt, but here it is applied to total external interest payments—including both public and private sectors—as recorded in the balance of payments. Among high-reserve countries,

² Reserve adequacy indicators vary in their interpretation across monetary regimes. In fully dollarized economies such as Panama, reserves mainly reflect fiscal liquidity considerations, making standard reserve-to-GDP benchmarks less directly comparable.

FIGURE 6.3 • Net Interest Payments by Level of Reserves in Latin America and the Caribbean

Source: IDB staff calculations, based on IMF International Financial Statistics.

Note: The figure shows debt securities interest payments relative to GDP, split between high- and low-reserve countries. Countries with reserves above 20 percent of GDP are classified as high reserve and include Guatemala, Honduras, Paraguay, Peru, and Uruguay. Low-reserve countries include Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Mexico, and Panama. In Panel A, the solid lines represent the group average, while the dashed lines correspond to the group median. As shown in Panels B and C, the decomposition of changes in

interest payments as a share of GDP follows the standard identity: $\Delta\left(\frac{I}{Y}\right)_t = \frac{r_{t-1} * \Delta D_{t-1}}{Y_t} + \frac{D_{t-1} \Delta r_t}{Y_t} - \left(\frac{I_{t-1}}{Y_{t-1}}\right) \left(\frac{\Delta Y_t}{Y_t}\right)$, where I denotes

interest payments, D the debt security stock, r the implicit interest rate, and Y nominal GDP. The first term captures the effect of changes in debt stocks ("new debt"), the second term isolates the effect of changes in interest rates, and the third term reflects the impact of nominal GDP growth on the interest-to-GDP ratio. The implicit rate is defined as

$$r_t = \frac{I_t}{D_{t-1}}$$

the rise in interest payments since 2023 is explained mostly by higher financing costs, as global interest rates pass through to the cost of outstanding debt. In the third quarter of 2024, interest payments increased even as debt was amortized, indicating that rates, not volumes, were doing the work. The more recent quarters contrast with the third quarter of 2024 and show a partial reversal, likely reflecting refinancing at better terms, with an increase in new debt issuance and a decline in the rate component.

The story was different for low-reserve countries, where the main driver was new debt issuance. Interest payments rose even without a major increase in rates, and nominal GDP growth provided little relief. This reflects a more persistent constraint: greater dependence on new borrowing amid tighter global conditions, reflecting the region's sensitivity to the global dollar cycle, and less room to absorb higher financing costs.

Countries with lower reserves have been subject to a double penalty: greater reliance on new borrowing and a reduced capacity to absorb higher global interest rates. This dynamic compounded existing vulnerabilities, as higher rates amplified legacy debt burdens and placed additional pressure on public finances and external balances, particularly in economies with limited buffers or more fragile market access.

Financing the Region's Current Account Deficit

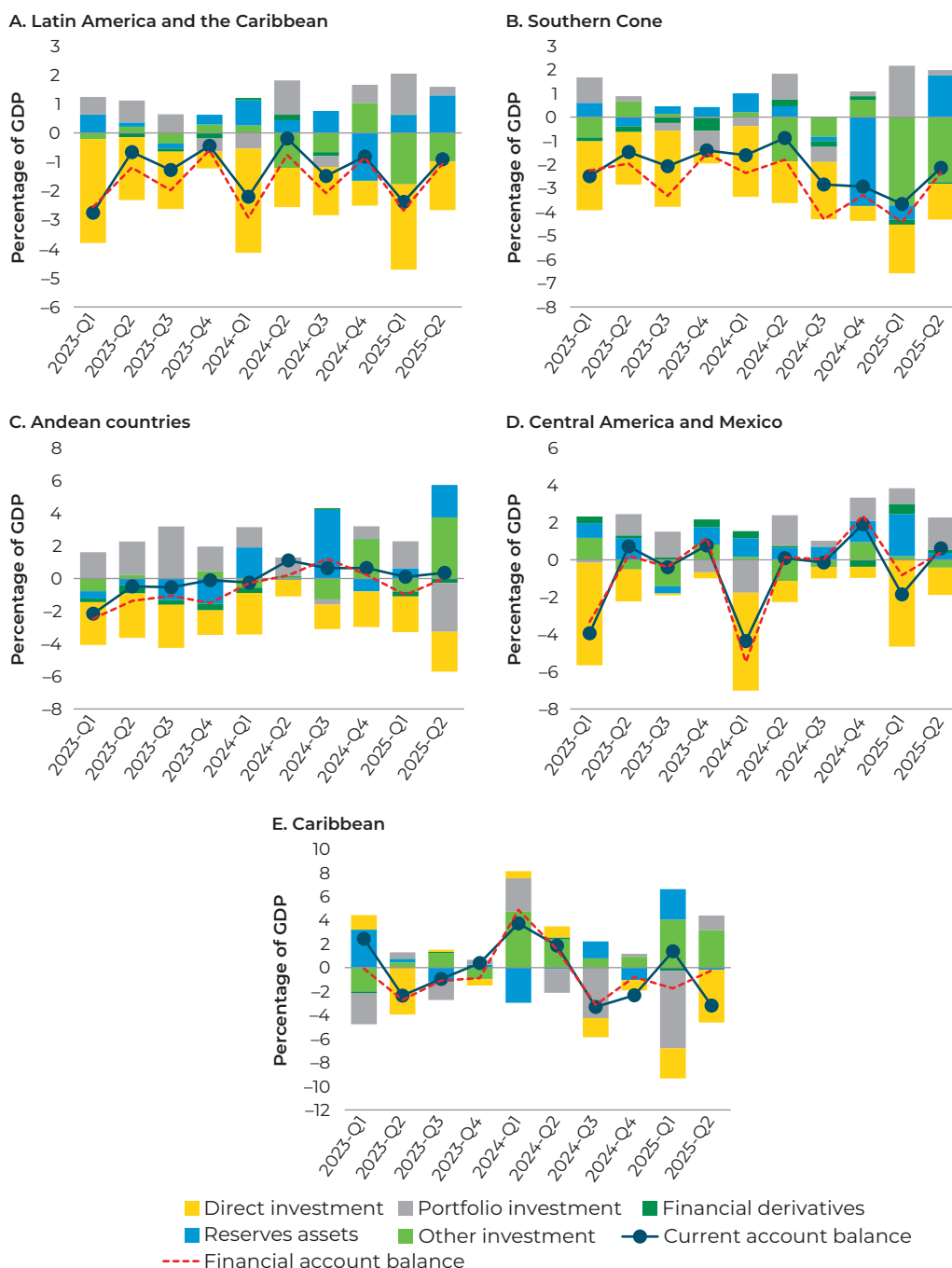
A look at how Latin America and the Caribbean financed its current account deficits in 2023 and 2024 reveals a mixed picture (Figure 6.4). Foreign direct investment remained the main source of financing, covering a substantial share of the external gap, but it did not increase even as financing needs rose in late 2023 and early 2024. At the same time, portfolio inflows weakened, with net outflows emerging in latter quarters, particularly in the Southern Cone and in Central America and Mexico. As a result, financing relied increasingly on reserve drawdowns through late 2024 and on official lending in 2025. Overall, the pattern points to a medium-term vulnerability: Financing needs grew, while FDI remained flat, debt-creating inflows took on a larger role, and reserve buffers were thinner than in previous cycles.

Across subregions, the financing mixture shifted in uneven ways. FDI remained present but fell short of covering external gaps, particularly in the Andean region and in Central America and Mexico, where other sources took on a larger role. Portfolio flows still mattered, especially in the Southern Cone, but their contribution was increasingly volatile.

What changed most visibly was the growing weight of other investments, including official and multilateral lending. By 2025, this category had become the dominant financing source in the Southern Cone, surpassing both FDI and portfolio flows. This shift reflected the expanding role of nonmarket financing as global conditions tightened and private capital flows softened.

Reserve drawdowns also played a larger role. Throughout 2024, they became more frequent in Central America and the Caribbean, where external buffers were used more actively to smooth financing pressures and bridge short-term gaps.

Beyond short-term financing dynamics, longer-term investment patterns started to reshape the region's external position. Mexico attracted new high-tech investment, including the proposed building of a facility in Guadalajara to assemble Nvidia's GB200 superchips, announced by Foxconn in 2025. This reinforced Mexico's role in global

FIGURE 6.4 • Financial Account Balance

Source: IDB staff calculations, based on IMF International Financial Statistics.

Note: The figure shows the composition of financial flows used to finance the current account balance in Latin America and the Caribbean, expressed as a share of GDP. The bars represent net flows by instrument, with "other investments" including loans and official disbursements, and the negative bars show the inflows used to finance the current account deficit. The dashed line shows the sum of the financial components, and the solid line shows the current account balance. Panels correspond to Latin America and the Caribbean and the four subregions.

electronics supply chains and aligned with a broader shift in its export structure as, for the first time since 2014, exports of mechanical and computing equipment to the United States exceeded exports of automobiles, with computing-related exports doubling in early 2025. As noted by Ayres, Izquierdo, and Parrado (2025), such transformations are more likely to generate broader regional gains when supported by deeper regional integration and stronger value-chain linkages.

At the same time, investment in critical minerals, particularly in copper and lithium, has rebounded across the region, as discussed in Chapter 2. Following a collapse in 2020, project announcements surged in 2022–24 to their highest level in over a decade. While copper remains the anchor, the rapid expansion of lithium investment linked to battery and electric-vehicle supply chains sets this cycle apart from earlier waves.

Looking Ahead: Strengthening External Resilience

The experience of 2025 showed how external conditions in Latin America and the Caribbean shifted in response to policy changes and evolving global financing dynamics. Trade balances, capital flows, and reserve positions moved significantly over the year, but, in many cases, these shifts reflected temporary factors—such as tariff exemptions, commodity movements, or official disbursements—rather than structural changes.

Multilateral and official financing helped smooth the adjustment, covering short-term gaps as portfolio flows weakened and FDI remained flat. Reserve buffers were also used more actively in several cases. These tools supported the transition but did not alter the underlying external position.

Looking ahead, resilience will depend less on temporary support and more on the composition and quality of trade and capital flows, supported by credible macroeconomic policy and adequate buffers. In a more uncertain global environment, the ability to manage external shocks will rest on fundamentals.

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